

Internal Revenue bulletin

Bulletin No. 2003-9
March 3, 2003

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 9035, page 528.

Final regulations under section 1041 of the Code relate to the tax treatment of redemptions, during marriage or incident to divorce, of stock in a corporation owned by a spouse or a former spouse.

T.D. 9038, page 524.

REG-126485-01, page 542.

Temporary and proposed regulations under section 368 of the Code provide guidance with respect to statutory mergers and consolidations. These regulations also provide that the merger of a domestic corporation into a domestic disregarded entity can qualify as a statutory merger or consolidation. A public hearing on the proposed regulations is scheduled for May 21, 2003.

REG-103580-02, page 543.

Proposed regulations under section 721 of the Code describe the tax consequences of certain noncompensatory options and convertible instruments issued by partnerships. The regulations provide that section 721 generally applies to the exercise of a noncompensatory option. The regulations also modify the rules under section 704(b) regarding the determination of the partners' distributive shares of partnership items, and provide that the holder of a noncompensatory option is treated as a partner under certain circumstances. A public hearing is scheduled for May 20, 2003.

Notice 2003-15, page 540.

Finality of foreign adoptions. This notice provides a proposed revenue procedure that would establish certain safe harbors for determining the finality of the adoption of eligible foreign-born children for purposes of the adoption credit and the exclusion for employer-provided assistance for qualified adoption expenses. Comments are requested by June 2, 2003.

ADMINISTRATIVE

T.D. 9036, page 533.

Final regulations under section 6103 of the Code permit the IRS to authorize agencies with access to returns and return information to redisclose returns and return information, with the approval of the Commissioner, to any authorized recipient set forth in section 6103, subject to the same restrictions and conditions, and for the same purposes, as if the recipient had received the information from the IRS directly.

T.D. 9037, page 535.

Final regulations under section 6103 of the Code authorize the disclosure of additional tax information to the Bureau of the Census to better meet the Bureau's program objectives, which include the Longitudinal Employer-Household Dynamics (LEHD) project and the Survey of Income and Program Participation (SIPP) project.

Finding Lists begin on page ii.

Index for January and February begins on page iv.



Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court

decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–2: Definitions of terms.

T.D. 9038

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Statutory Mergers and Consolidations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that define the term *statutory merger or consolidation* as that term is used in section 368(a)(1)(A). These regulations affect corporations engaging in statutory mergers and consolidations, and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG–126485–01) on this subject on page 542 of this Bulletin.

DATES: *Effective Date:* These regulations are effective January 24, 2003.

FOR FURTHER INFORMATION CONTACT: Richard M. Heinecke or Reginald Mombrun at (202) 622–7930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

A. Section 368(a) Generally

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations specifically described in section 368(a). Section 368(a)(1)(A) provides that the term *reorganization* includes “a statutory merger or consolidation.” Section 1.368–2(b)(1) currently provides that a statutory merger or consolidation must be “effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia.”

B. Disregarded Entities Generally

A business entity (as defined in §301.7701–2(a)) that has only one owner may be disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include a domestic single member limited liability company that does not elect to be classified as a corporation for federal tax purposes, a corporation (as defined in §301.7701–2(b)) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)) (hereinafter referred to as “QRS”), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)) (hereinafter sometimes referred to as “QSub”).

Because a QRS and QSub are corporations under state law, state merger laws generally permit them to merge with other corporations. In addition, many state merger laws permit a limited liability company (LLC) to merge with another LLC or with a corporation.

C. Previous Proposals of Regulations

On May 16, 2000, the IRS and Treasury issued a notice of proposed rulemaking (REG–106186–98, 2000–1 C.B. 1226 [65 FR 31115]) (hereinafter referred to as the 2000 proposed regulations) providing that neither the merger of a disregarded entity into a corporation nor the merger of a corporation into a disregarded entity would qualify as a reorganization under section 368(a)(1)(A). While commentators generally agreed that the merger of a disregarded entity into a corporation should not qualify as a reorganization under section 368(a)(1)(A), commentators asserted that the merger of a corporation into a disregarded entity with a corporate owner should be able to qualify as a reorganization under section 368(a)(1)(A).

On November 15, 2001, after consideration of the comments received regarding the 2000 proposed regulations, the IRS and Treasury withdrew the 2000 proposed regulations (REG–106186–98; Announcement 2001–121, 2001–2 C.B. 584 [66 FR 57400]) and issued another notice of proposed rulemaking (REG–126485–01, 2001–2 C.B. 555 [66 FR 57400]) (hereinafter referred to as the 2001 proposed regulations).

The 2001 proposed regulations provide that, for purposes of section 368(a)(1)(A), a statutory merger or consolidation must be effected pursuant to the laws of the United States or a State or the District of Columbia. Pursuant to such laws, the following events must occur simultaneously at the effective time of the transaction: (1) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and (2) the combining entity of each transferor unit ceases its separate legal existence for all purposes. For this purpose, a combining entity is a business entity that is a corporation (as defined in §301.7701–2(b)) that is not a disregarded entity) and a combining unit is a combining entity and all of its disregarded entities.

The 2001 proposed regulations provide that the merger of a disregarded entity into a corporation will not qualify as a statutory merger or consolidation under section 368(a)(1)(A) because all of the transferor unit’s assets may not be transferred to the transferee unit and the separate legal existence of the combining entity of the transferor unit does not terminate as a matter of law. The 2001 proposed regulations, however, generally provide that the merger of a corporation into a disregarded entity will qualify as a statutory merger or consolidation if it satisfies the requirements of the regulations.

No public hearing regarding the 2001 proposed regulations was requested or held. Nonetheless, a number of written comments were received.

Explanation of Provisions

The IRS and Treasury have studied the comments received regarding the 2001 proposed regulations. Although the IRS and Treasury are continuing to study a number of the comments received regarding the proposed regulations, in response to a number of comments requesting immediate guidance in this area upon which taxpayers may rely, the IRS and Treasury are promulgating these regulations as temporary regulations in this Treasury Decision. The

temporary regulations retain the general framework of the 2001 proposed regulations, but make certain modifications in response to comments received. The following sections describe a number of the most significant comments and the extent to which they have been incorporated in these temporary regulations. Further changes to the temporary regulations, however, are possible before these regulations are finalized.

A. Definition of Combining Entity

As described above, the 2001 proposed regulations define a combining entity as a business entity that is a corporation that is not a disregarded entity. Although the preamble to the 2001 proposed regulations clarifies that, for this purpose, the term corporation is defined as provided in §301.7701-2(b), commentators requested that clarification also be provided in the text of the regulations. In response to these comments, the temporary regulations provide that a combining entity is a corporation (as defined in §301.7701-2(b)) that is not a disregarded entity.

B. The All of the Assets Requirement

As stated above, the 2001 proposed regulations require that all of the assets of a transferor unit become the assets of a transferee unit. A number of comments were received regarding this requirement. The following paragraphs describe these comments and the extent to which the temporary regulations reflect them.

One comment suggested that the regulations be amended to clarify that whether the all of the assets requirement is satisfied is determined by reference to the assets of the transferor unit immediately prior to the merger. These temporary regulations add an example that illustrates that a transaction that is preceded by a distribution by the transferor unit to its shareholders may qualify as a statutory merger under these temporary regulations, even if the “substantially all” requirement applicable to certain other types of reorganizations would not be satisfied. The example is provided solely to illustrate the meaning of the all of the assets requirement. No inference is intended regarding the shareholder level and other tax consequences of the transaction described therein.

Another comment stated that the proposed regulations are unclear as to whether

a transaction in which an entity that is disregarded as an entity separate from the combining entity of the transferor unit becomes an entity that is disregarded as an entity separate from the combining entity of the transferee unit satisfies the all of the assets requirement. These temporary regulations amend *Example 2* of the 2001 proposed regulations, as described below, to clarify that this transaction may satisfy the all of the assets requirement and, therefore, qualify as a statutory merger or consolidation.

C. The Cessation of Separate Legal Existence Requirement

The 2001 proposed regulations require that the combining entity of each transferor unit “ceases its separate legal existence for all purposes.” One comment requested that the phrase “for all purposes” be deleted from this requirement. The comment suggested that under some corporate laws a merged corporation may continue its existence for a specified time period and for certain limited purposes, such as bringing and defending against lawsuits. This limited continued existence of a combining entity of a transferor unit, the comment suggested, should not prevent a transaction from being treated as failing to satisfy the requirement that the combining entity of each transferor unit cease its separate legal existence for all purposes.

The IRS and Treasury do not believe that the deletion of “for all purposes” from the regulation will alter the terms of the requirement. Nonetheless, these temporary regulations provide that this requirement will be satisfied even if, pursuant to the laws of the United States or a State or the District of Columbia, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the all of the assets requirement.

D. Example 2 of the 2001 Proposed Regulations

A number of comments were received regarding *Example 2* of the 2001 proposed regulations, which involves the merger of a target corporation into a disregarded entity. The last sentence of the facts of *Example 2* states that, “[p]rior to the transaction, [the combining entity of the transferor unit] is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes.” One commentator indicated that it is not clear why this fact is relevant to the conclusion that the transaction qualifies as a statutory merger or consolidation and suggested either deleting or clarifying this fact.

As described above, in order to qualify as a statutory merger or consolidation, all of the assets of a transferor unit must become assets of the transferee unit. In order to determine whether this requirement has been satisfied, it is necessary to know whether the combining entity of the transferor unit owns the interests of any entity that is disregarded as an entity separate from its owner for federal tax purposes. The last sentence of the facts of *Example 2* was merely intended to convey the fact that the only assets of the transferor unit were those that the combining entity owned directly. To clarify the significance of this fact, the temporary regulations amend the analysis in *Example 2* to indicate that the transaction would still qualify as a statutory merger or consolidation even if the combining entity of the transferor unit were treated as owning assets of an entity that is disregarded as an entity separate from the combining entity of the transferor unit for federal tax purposes, provided that those assets become assets of the transferee unit.

E. Additional Examples

One commentator suggested that the scope of the proposed regulations be clarified through additional examples. The following paragraphs describe the suggested examples and the extent to which they have been incorporated in these temporary regulations.

1. QSub that becomes a C corporation

A QSub may cease to be a disregarded entity because of an event that renders the subsidiary ineligible for QSub status, such as a merger into an entity owned by a C corporation. For example, suppose Z, an S corporation, owns all of the stock of B, a QSub, and Z merges with and into X, an

entity that is disregarded as an entity separate from Y, a C corporation. B's status as a QSub will terminate at the end of the day on which the merger occurs. See Treas. Reg. §1.1361-5(a)(1)(iii). A commentator suggested that, in this case, it is not clear whether B is a member of the transferor unit. If B were treated as a member of the transferor unit, the transaction may not qualify as a statutory merger or consolidation because the assets of B may not become assets of the transferee unit. If, however, B were not treated as a member of the transferor unit, the transaction may qualify as a statutory merger or consolidation. The commentator suggested that B should not be treated as a member of the transferor unit. Alternatively, the commentator suggested that the principles of *Example 9* of §1.1361-5(b)(3) could be applied to this case. In *Example 9* of §1.1361-5(b)(3), the acquisition of the stock of a QSub is treated as a transfer of the QSub's assets followed by the transfer of those assets by the acquirer to a new corporation.

The IRS and Treasury agree with the commentator that the principles illustrated by *Example 9* of §1.1361-5(b)(3) apply to determine whether the merger of Z into X qualifies as a statutory merger or consolidation. In particular, the transaction should be treated as a transfer of B's assets to X followed by a transfer of such assets by X to a new corporation. Accordingly, the transaction may qualify as a statutory merger or consolidation provided that the other requirements of a statutory merger or consolidation are satisfied. These temporary regulations include an example illustrating this result.

2. Transitory surviving disregarded entity

One commentator suggested that the 2001 proposed regulations be amended to provide an example in which the surviving disregarded entity in an otherwise qualifying statutory merger or consolidation is transitory. For example, suppose corporation Z merges into X, an entity that is disregarded as separate from corporation Y. In the transaction, the shareholders of Z exchange their Z stock for Y stock. Immediately after the merger of Z into X and as part of a plan that includes that merger, X merges into Y. The commentator noted that, in Rev. Rul. 72-405, 1972-2 C.B. 217, the IRS held that a forward triangular merger

of a target corporation into a newly formed controlled corporation of a parent corporation followed by the liquidation of the controlled corporation into the parent corporation would be treated as a reorganization under section 368(a)(1)(C) rather than a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D). The commentator suggested that the principles of Revenue Ruling 72-405 should not be applied to prevent the merger of Z into X from qualifying as a reorganization under section 368(a)(1)(A).

The IRS and Treasury agree that the merger of Z into X followed by the merger of X into Y does not implicate the principles of Revenue Ruling 72-405. Because the merger of X into Y does not alter the identity of the tax owner of the former assets of X, that merger would be disregarded. The IRS and Treasury do not believe that an additional example is necessary to illustrate this result.

F. The Domestic Entity Requirement

The 2001 proposed regulations provide that a transaction in which any of the assets and liabilities of a combining entity of a transferor unit become assets and liabilities of one or more disregarded entities of the transferee unit cannot qualify as a statutory merger or consolidation unless such combining entity, the combining entity of the transferee unit, such disregarded entities, and each business entity through which the combining entity of the transferee unit holds its interests in such disregarded entities is organized under the laws of the United States or a State or the District of Columbia. One commentator suggested that where an entity that is disregarded as an entity separate from the combining entity of the transferor unit becomes an entity that is disregarded as an entity separate from the combining entity of the transferee unit, whether such disregarded entity is organized under the laws of the United States or a State or the District of Columbia is not relevant to whether the transaction qualifies as a statutory merger or consolidation. The IRS and Treasury agree and have clarified the domestic entity requirement to exclude such disregarded entities.

Another comment suggested that the domestic entity requirement be eliminated for the disregarded entity into which a target corporation is merged and each business entity through which the combining entity holds its interests in the disregarded en-

tity into which a target corporation is merged. Although these temporary regulations retain that requirement for those entities, as described in the preamble to the 2001 proposed regulations, the IRS and Treasury are continuing to consider further revisions to the regulations under section 368(a)(1)(A) to address statutory mergers and consolidations that involve one or more foreign corporations, including transactions involving a disregarded entity.

Special Analyses

It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Richard M. Heinecke, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.368-2, paragraph (b)(1) is revised to read as follows:

§1.368-2 Definition of terms.

* * * * *

(b)(1) For rules regarding statutory mergers or consolidations on or after January 24, 2003, see §1.368-2T(b)(1). For rules regarding statutory mergers or consolidations before January 24, 2003, see §1.368-

2(b)(1) as in effect before January 24, 2003 (See 26 CFR part 1, revised April 1, 2002).

* * * * *

Par. 3. Section 1.368-2T is added to read as follows:

§1.368-2T Definition of terms (temporary).

(a) [Reserved]. For further guidance, see §1.368-2(a).

(b)(1)(i) *Definitions.* For purposes of this paragraph (b)(1), the following terms shall have the following meanings:

(A) *Disregarded entity.* A disregarded entity is a business entity (as defined in §301.7701-2(a) of this chapter) that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include a domestic single member limited liability company that does not elect to be classified as a corporation for federal tax purposes, a corporation (as defined in §301.7701-2(b) of this chapter) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)).

(B) *Combining entity.* A combining entity is a business entity that is a corporation (as defined in §301.7701-2(b) of this chapter) that is not a disregarded entity.

(C) *Combining unit.* A combining unit is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal tax purposes.

(ii) *Statutory merger or consolidation generally.* For purposes of section 368(a)(1)(A), a statutory merger or consolidation is a transaction effected pursuant to the laws of the United States or a State or the District of Columbia, in which, as a result of the operation of such laws, the following events occur simultaneously at the effective time of the transaction—

(A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and

(B) The combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however,

that this requirement will be satisfied even if, pursuant to the laws of the United States or a State or the District of Columbia, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of paragraph (b)(1)(ii)(A) of this section.

(iii) *Statutory merger or consolidation involving disregarded entities.* A transaction effected pursuant to the laws of the United States or a State or the District of Columbia in which any of the assets and liabilities of a combining entity of a transferor unit become assets and liabilities of one or more disregarded entities of the transferee unit is not a statutory merger or consolidation within the meaning of section 368(a)(1)(A) and paragraph (b)(1)(ii) of this section unless such combining entity, the combining entity of the transferee unit, such disregarded entities other than entities that were disregarded entities of the transferor unit immediately prior to the transaction, and each business entity through which the combining entity of the transferee unit holds its interests in such disregarded entities is organized under the laws of the United States or a State or the District of Columbia.

(iv) *Examples.* The following examples illustrate the rules of paragraph (b)(1) of this section. In each of the examples, except as otherwise provided, each of V, Y, and Z is a domestic C corporation. X is a domestic limited liability company. Except as otherwise provided, X is wholly owned by Y and is disregarded as an entity separate from Y for federal tax purposes. The examples are as follows:

Example 1. Divisive transaction pursuant to a merger statute. (i) Under State W law, Z transfers some of its assets and liabilities to Y, retains the remainder of its assets and liabilities, and remains in existence following the transaction. The transaction qualifies as a merger under State W corporate law. Prior to the transaction, Y is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of Y, the combining entity and sole member of the transferee unit. In addition, the transaction does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because the separate legal existence of Z does not cease for all purposes. Accordingly, the transaction does not qualify as a statutory merger or consolidation under section 368(a)(1)(A).

Example 2. Merger of a target corporation into a disregarded entity in exchange for stock of the owner.

(i) Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y. Prior to the transaction, Z is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes.

(ii) The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for federal tax purposes, and Z ceases its separate legal existence for all purposes. Paragraph (b)(1)(iii) of this section does not apply to prevent the transaction from qualifying as a statutory merger or consolidation for purposes of section 368(a)(1)(A) because each of Z, Y, and X is a domestic entity. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A). The result would be the same if Z were treated as owning assets of an entity that is disregarded as an entity separate from Z, regardless of whether such disregarded entity became an entity disregarded as an entity separate from Y as a result of the transaction, or merged into X or a domestic entity disregarded as an entity separate from Y.

Example 3. Merger of a target S corporation that owns a QSub into a disregarded entity. (i) The facts are the same as in *Example 2*, except that Z is an S corporation and owns all of the stock of U, a QSub.

(ii) The deemed formation by Z of U pursuant to §1.1361-5(b)(1) (as a consequence of the termination of U's QSub election) is disregarded for federal income tax purposes. The transaction is treated as a transfer of the assets of U to X, followed by X's transfer of these assets to U in exchange for stock of U. See §1.1361-5(b)(3), *Example 9*. The transaction will, therefore, satisfy the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and U, the sole members of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as own-

ing for federal tax purposes, and Z ceases its separate legal existence for all purposes. Paragraph (b)(1)(iii) of this section does not apply to prevent the transaction from qualifying as a statutory merger or consolidation for purposes of section 368(a)(1)(A) because each of Z, Y, and X is a domestic entity. Moreover, the deemed transfer of the assets of U in exchange for U stock does not cause the transaction to fail to qualify as a statutory merger or consolidation. See §368(a)(2)(C). Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 4. Triangular merger of a target corporation into a disregarded entity. (i) The facts are the same as in *Example 2*, except that V owns 100 percent of the outstanding stock of Y and, in the merger of Z into X, the Z shareholders exchange their stock of Z for stock of V. In the transaction, Z transfers substantially all of its properties to X.

(ii) The transaction is not prevented from qualifying as a statutory merger or consolidation under section 368(a)(1)(A), provided the requirements of section 368(a)(2)(D) are satisfied. Because the assets of X are treated for federal tax purposes as the assets of Y, Y will be treated as acquiring substantially all of the properties of Z in the merger for purposes of determining whether the merger satisfies the requirements of section 368(a)(2)(D). As a result, the Z shareholders that receive stock of V will be treated as receiving stock of a corporation that is in control of Y, the combining entity of the transferee unit that is the acquiring corporation for purposes of section 368(a)(2)(D). Accordingly, the merger will satisfy the requirements of section 368(a)(2)(D).

Example 5. Merger of a target corporation into a disregarded entity owned by a partnership. (i) The facts are the same as in *Example 2*, except that Y is organized as a partnership under the laws of State W and is classified as a partnership for federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section. All of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit because neither X nor Y qualifies as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 6. Merger of a disregarded entity into a corporation. (i) Under State W law, X merges into Z. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of X (but not the assets and liabilities of Y other than those of X) become the assets and liabilities of Z and X's separate legal existence ceases for all purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of a transferor unit do not become the assets and liabilities of one or more members of the transferee unit. The transaction also does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because X does not qualify as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 7. Merger of a corporation into a disregarded entity in exchange for interests in the disregarded entity. (i) Under State W law, Z merges into

X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger of Z into X, the Z shareholders exchange their stock of Z for interests in X so that, immediately after the merger, X is not disregarded as an entity separate from Y for federal tax purposes. Following the merger, pursuant to §301.7701-3(b)(1)(i) of this chapter, X is classified as a partnership for federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because immediately after the merger X is not disregarded as an entity separate from Y and, consequently, all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 8. Merger transaction preceded by distribution. (i) Z operates two unrelated businesses, Business P and Business Q, each of which represents 50 percent of the value of the assets of Z. Y desires to acquire and continue operating Business P, but does not want to acquire Business Q. Pursuant to a single plan, Z sells Business Q for cash to parties unrelated to Z and Y in a taxable transaction, and then distributes the proceeds of the sale *pro rata* to its shareholders. Then, pursuant to State W law, Z merges into Y. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z related to Business P become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their Z stock for Y stock. Prior to the transaction, Z is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes.

(ii) The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z ceases its separate legal existence for all purposes. Paragraph (b)(1)(iii) of this section does not apply to prevent the transaction from qualifying as a statutory merger or consolidation for purposes of section 368(a)(1)(A) because each of Z and Y is a domestic entity. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

(v) **Effective dates.** This paragraph (b)(1) applies to transactions occurring on or after January 24, 2003. Taxpayers, however, may apply these regulations in whole, but not in part, to transactions occurring before January 24, 2003, provided that, if the taxpayer is the acquiring corporation (or a shareholder of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation, such as a shareholder of an

acquiring S corporation), the target corporation (and the shareholders of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation) also applies these regulations in whole, but not in part, to the transaction, and if the taxpayer is the target corporation (or a shareholder of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation), the acquiring corporation (and the shareholders of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation) also applies these regulations in whole, but not in part, to the transaction. For all other transactions, see §1.368-2(b)(1) as in effect before January 24, 2003 (See 26 CFR part 1, revised April 1, 2002).

(b)(2) through (k) [Reserved]. For further guidance, see §1.368-2(b)(2) through (k).

David A. Mader,
Assistant Deputy Commissioner of
Internal Revenue.

Approved January 17, 2003.

Pamela F. Olson,
Assistant Secretary of
the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 23, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 24, 2003, 68 F.R. 3384)

Section 1041.—Transfers of Property Between Spouses or Incident to Divorce

26 CFR 1.1041-1T: Treatment of transfers of property between spouses or incident to divorce (temporary).

T.D. 9035

**DEPARTMENT OF THE
TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602**

**Constructive Transfers and
Transfers of Property to a
Third Party on Behalf of a
Spouse**

AGENCY: Internal Revenue Service (IRS),
Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the tax treatment of redemptions, during marriage or incident to divorce, of stock in a corporation owned by a spouse or former spouse.

DATE: *Effective Date:* These regulations are effective January 13, 2003.

Applicability Date: These regulations are applicable to redemptions of stock on or after January 13, 2003, that are pursuant to instruments in effect after January 13, 2003. These regulations are also applicable to redemptions before January 13, 2003, or that are pursuant to instruments in effect before January 13, 2003, if the spouses or former spouses execute a written agreement on or after August 3, 2001, that satisfies the requirements of §1.1041-2(c)(1) or (2).

FOR FURTHER INFORMATION CONTACT: Edward C. Schwartz at (202) 622-4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1751. Responses to this collection of information are required for certain taxpayers to redeem stock in a corporation and utilize the special rule in §1.1041-2(c) of these regulations.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent/recordkeeper varies from 20 minutes to one hour, depending on individual circumstances, with an estimated average of 30 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Of-

ficer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On August 3, 2001, the IRS and Treasury Department published in the **Federal Register** a notice of proposed rulemaking under section 1041 relating to certain redemptions, during marriage or incident to divorce, of stock in a corporation owned by a spouse or former spouse (REG-107151-00, 2001-2 C.B. 370 [66 FR 40659]). Written and electronic comments were solicited, and a public hearing was scheduled for December 14, 2001. Several comments were received and are discussed below. Because no requests to speak were timely received, the public hearing was cancelled. After consideration of all comments received, the proposed regulations under section 1041 are adopted as revised by this Treasury decision.

Explanation and Summary of Comments

1. Special Rules in Cases of Written Agreements Between the Spouses

The proposed regulations provided generally that if a corporation redeemed stock owned by a transferor spouse and the redemption resulted in a constructive distribution to the nontransferor spouse under applicable tax law, then the redemption would be taxable to the nontransferor spouse as if the nontransferor spouse had actually received the redemption proceeds. The proposed regulations contained a special rule in §1.1041-2(c) allowing the spouses the option of treating the redemption as resulting in a constructive distribution to the nontransferor spouse, and therefore taxable to the nontransferor spouse, even if the redemption would not result in a constructive distribution to the nontransferor spouse under applicable tax law. The proposed regulations provided that the spouses could elect the special rule by providing in the divorce or separation instrument, or other written agreement, that

the spouses must file their federal income tax returns in a manner that reflects that the transferor spouse transferred the redeemed stock to the nontransferor spouse in exchange for the redemption proceeds and the corporation redeemed the stock from the nontransferor spouse in exchange for the redemption proceeds. The proposed regulations also provided that the special rule would be effective for written agreements executed on or after August 3, 2001, that met these requirements.

Commentators expressed concern that the proposed regulations contained no provision addressing the situation where the redemption results in a constructive distribution to the nontransferor spouse under applicable tax law, but the spouses nevertheless would like to agree that the redemption will be treated as a redemption distribution to the transferor spouse. They suggested that the final regulations expand the special rule in §1.1041-2(c) to allow the spouses to agree in the divorce or separation instrument, or other valid written agreement, that the redemption will be taxable to the transferor spouse notwithstanding that the redemption might otherwise result in a constructive distribution to the nontransferor spouse under applicable tax law.

The IRS and Treasury Department believe that this suggestion is consistent with the policy of section 1041 and its legislative history, which is to provide flexibility to spouses and former spouses concerning the structuring of their property transfers during marriage and incident to divorce. Accordingly, this suggestion has been adopted in §1.1041-2(c) of the final regulations. New *Example 2* in §1.1041-2(d) illustrates the application of this new special rule.

The manner of electing the special rule also has been modified somewhat in the final regulations. Under the final regulations, the spouses can elect the special rule by expressly providing, in a divorce or separation instrument or other valid written agreement, that expressly supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption, their mutual intent concerning whether the redemption should be treated as a redemption distribution to the transferor spouse or to the nontransferor spouse. The IRS and Treasury Department

will treat a divorce or separation instrument or other valid written agreement executed on or after August 3, 2001, and before May 13, 2003, that meets the requirements of the special rule of the proposed regulations as also meeting the requirements of the special rule in paragraph (c)(2) of the final regulations.

2. Constructive Distribution Standard

Some commentators also expressed concern that taxpayers and divorce practitioners may not be aware of the situations in which a redemption of stock owned by the transferor spouse could result in a constructive distribution to the nontransferor spouse under applicable tax law. They therefore suggested that the final regulations either provide that the redemption will be treated as a redemption distribution to the transferor spouse regardless of applicable tax law, unless the spouses provide otherwise in a written agreement and file their federal income tax returns accordingly, or provide specific definitions and examples of situations in which a redemption would result in a constructive distribution to the nontransferor spouse under applicable tax law.

The IRS and Treasury Department continue to believe that the approach in the proposed regulations is appropriate. Under existing tax law, a redemption of stock owned by one shareholder may result in a constructive distribution to another shareholder if such nonredeeming shareholder has a primary and unconditional obligation to purchase the redeeming shareholder's stock. See Rev. Rul. 69-608, 1969-2 C.B. 42, *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947), and *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966). This "primary and unconditional obligation" standard applies to all redemptions, including those involving stock of closely held corporations by spouses or former spouses. A rule that provides that a redemption of stock owned by the transferor spouse will always be treated as a redemption distribution to the transferor spouse would be inconsistent with this established law. Furthermore, if taxpayers and divorce practitioners are uncertain about the application of the "primary and unconditional obligation" standard, they may take advantage of the special rules of §1.1041-2(c), which permit spouses to avoid any question of whether a redemption results in a constructive distribution to the nontrans-

feror spouse under applicable tax law relating to the primary and unconditional obligation standard by providing in a written agreement which spouse will bear the tax consequences of the redemption.

3. Withdrawal of §1.1041-1T(c), Q&A-9

Section 1.1041-1T(c), Q&A-9, of the temporary Income Tax Regulations provides that there are three situations in which a transfer of property to a third party on behalf of a spouse or former spouse will qualify under section 1041 (provided all other requirements of that section are met): (1) if such transfer is required by the divorce or separation instrument; (2) if the transfer is pursuant to a written request of the other spouse; and (3) where the transferor spouse receives a written consent or ratification from the nontransferor spouse. Under Q&A-9, a transfer of property made to a third party on behalf of a spouse is treated first as a deemed transfer of the property made directly to the nontransferor spouse in a transfer to which section 1041 applies, and then as a deemed transfer of the property from the nontransferor spouse to the third party in a transaction to which section 1041 does not apply.

Two commentators recommended that Q&A-9 be withdrawn. They suggested that retaining that provision would lead to confusion since it would apply to all transfers of property other than stock redemptions while this final regulation would apply only to stock redemptions. Another commentator advocated replacing existing Q&A-9 with a single standard applicable to all transfers of property to third parties under which the tax consequences of the transfer would follow the transfer's form unless the spouses agreed in writing otherwise.

The "on behalf of" standard has not led to the same confusion and litigation outside the area of stock redemptions because, in such cases, it does not conflict with any other standard of tax law. See, e.g., *Ingham v. United States*, 167 F.3d 1240 (9th Cir. 1999). In addition, as discussed above, a single standard applicable to all transfers of property to third parties under which the tax consequences of the transfer would follow the transfer's form would be inconsistent with the primary and unconditional obligation standard applicable to stock redemptions under existing tax law. Consequently, the IRS and Treasury Department

continue to believe that the final regulations should be limited to stock redemptions and that Q&A-9 should not be withdrawn.

4. Use of IRS Form to Designate Intent

One commentator proposed that the final regulations include a requirement that the spouses or former spouses attach a form to their federal income tax returns showing which spouse or former spouse has the tax consequences of the redemption. After careful consideration, the IRS and Treasury Department have concluded that requiring spouses, and particularly spouses who have divorced or are divorcing, to complete and file an additional form in order to obtain the result of the special rules would unnecessarily increase the administrative burden on taxpayers and on the IRS. The divorce or separation instrument, or other valid written agreement of the spouses, provides adequate evidence of the spouses' intent regarding which spouse has the tax consequences of the redemption.

5. Legal Guardians and/or Executors of Estates of Spouses

One commentator suggested that the final regulations provide specific authority for a legal guardian of a spouse or former spouse or the executor of a spouse's or former spouse's estate to elect the application of one of the special rules of §1.1041-2(c). However, a legal guardian, custodian, or executor of an estate that has the general authority to act on behalf of a spouse or former spouse (or his or her estate) for federal income tax purposes needs no additional or special authority to elect one of the special rules under §1.1041-2(c). Accordingly, this suggestion has not been adopted.

6. Other Changes

In an effort to improve the clarity of the final regulations, the order of the two paragraphs in §1.1041-2(a) has been reversed and conforming changes have been made in the remainder of the final regulations. Also, the final regulations remove the provision of the proposed regulations that would have limited their application to transactions in which both spouses or former spouses own stock immediately before or after the redemption. On further reflection, the IRS and Treasury Department believe it is appropriate to apply the regu-

lations to all stock redemptions, regardless of whether both spouses own stock of the corporation before or after the redemption.

7. Effective Date

One comment was received suggesting that the effective date provision of the final regulations be changed to include all stock redemptions that were pending on the day the proposed regulations were issued (August 2, 2001) and to include all cases involving stock redemptions at issue on that date at any level of audit, review, appeal, or collection by the IRS or before the Tax Court or any other federal court. It was argued that this proposal would be consistent with the current state of the law and would resolve numerous cases involving taxpayers and the IRS. Adopting this suggestion would have the effect of making the application of the final regulations retroactive. Apart from the special rules of §1.1041-2(c), which are based upon the stated intent of the spouses, the IRS and Treasury do not believe it is appropriate to apply the final regulations retroactively. Therefore, the final regulations do not adopt this suggestion.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Edward C. Schwartz of the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.1041-1T, paragraph (c) is amended by adding a sentence at the end of A-9 to read as follows:

§1.1041-1T Treatment of transfers of property between spouses or incident to divorce (temporary).

* * * * *

(c) * * *

A-9: * * * This A-9 shall not apply to transfers to which §1.1041-2 applies.

* * * * *

Par. 3. Section 1.1041-2 is added to read as follows:

§1.1041-2 Redemptions of stock.

(a) *In general*—(1) *Redemptions of stock not resulting in constructive distributions.* Notwithstanding Q&A-9 of §1.1041-1T(c), if a corporation redeems stock owned by a spouse or former spouse (transferor spouse), and the transferor spouse's receipt of property in respect of such redeemed stock is not treated, under applicable tax law, as resulting in a constructive distribution to the other spouse or former spouse (nontransferor spouse), then the form of the stock redemption shall be respected for federal income tax purposes. Therefore, the transferor spouse will be treated as having received a distribution from the corporation in redemption of stock.

(2) *Redemptions of stock resulting in constructive distributions.* Notwithstanding Q&A-9 of §1.1041-1T(c), if a corporation redeems stock owned by a transferor spouse, and the transferor spouse's receipt of property in respect of such redeemed stock is treated, under applicable tax law, as resulting in a constructive distribution to the nontransferor spouse, then the redeemed stock shall be deemed first to be transferred by the transferor spouse to the nontransferor spouse and then to be transferred by the nontransferor spouse to

the redeeming corporation. Any property actually received by the transferor spouse from the redeeming corporation in respect of the redeemed stock shall be deemed first to be transferred by the corporation to the nontransferor spouse in redemption of such spouse's stock and then to be transferred by the nontransferor spouse to the transferor spouse.

(b) *Tax consequences*—(1) *Transfers described in paragraph (a)(1) of this section.* Section 1041 will not apply to any of the transfers described in paragraph (a)(1) of this section. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(2) *Transfers described in paragraph (a)(2) of this section.* The tax consequences of each deemed transfer described in paragraph (a)(2) of this section are determined under applicable provisions of the Internal Revenue Code as if the spouses had actually made such transfers. Accordingly, section 1041 applies to any deemed transfer of the stock and redemption proceeds between the transferor spouse and the nontransferor spouse, provided the requirements of section 1041 are otherwise satisfied with respect to such deemed transfer. Section 1041, however, will not apply to any deemed transfer of stock by the nontransferor spouse to the redeeming corporation in exchange for the redemption proceeds. See section 302 for rules relating to the tax consequences of certain redemptions; redemptions characterized as distributions under section 302(d) will be subject to section 301 if received from a Subchapter C corporation or section 1368 if received from a Subchapter S corporation.

(c) *Special rules in case of agreements between spouses or former spouses*—(1) *Transferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, and shall not be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, if a divorce or separation instrument,

or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as a redemption distribution to the transferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(2) *Nontransferor spouse taxable.* Notwithstanding applicable tax law, a transferor spouse's receipt of property in respect of the redeemed stock shall be treated as resulting in a constructive distribution to the nontransferor spouse for purposes of paragraph (a)(2) of this section, and shall not be treated as a distribution to the transferor spouse in redemption of such stock for purposes of paragraph (a)(1) of this section, if a divorce or separation instrument, or a valid written agreement between the transferor spouse and the nontransferor spouse, expressly provides that—

(i) Both spouses or former spouses intend for the redemption to be treated, for federal income tax purposes, as resulting in a constructive distribution to the nontransferor spouse; and

(ii) Such instrument or agreement supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption.

(3) *Execution of agreements.* For purposes of this paragraph (c), a divorce or separation instrument must be effective, or a valid written agreement must be executed by both spouses or former spouses, prior to the date on which the transferor spouse (in the case of paragraph (c)(1) of this section) or the nontransferor spouse (in the case of paragraph (c)(2) of this section) files such spouse's first timely filed federal income tax return for the year that includes the date of the stock redemption, but no later than the date such return is due (including extensions).

(d) *Examples.* The provisions of this section may be illustrated by the following examples:

Example 1. Corporation X has 100 shares outstanding. A and B each own 50 shares. A and B divorce. The divorce instrument requires B to purchase A's shares, and A to sell A's shares to B, in exchange for \$100x. Corporation X redeems A's shares for \$100x. Assume that, under applicable tax law, B has a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption results in a constructive distribution to B. Also assume that the special rule of paragraph (c)(1) of this section does not apply. Accordingly, under paragraphs (a)(2) and (b)(2) of this section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for \$100x in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the \$100x to A in a transfer to which section 1041 applies.

Example 2. Assume the same facts as *Example 1*, except that the divorce instrument provides as follows: "A and B agree that the redemption will be treated for federal income tax purposes as a redemption distribution to A." The divorce instrument further provides that it "supersedes all other instruments or agreements concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(1) of this section and under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X and shall not be treated as resulting in a constructive distribution to B. See section 302.

Example 3. Assume the same facts as *Example 1*, except that the divorce instrument requires A to sell A's shares to Corporation X in exchange for a note. B guarantees Corporation X's payment of the note. Assume that, under applicable tax law, B does not have a primary and unconditional obligation to purchase A's stock, and therefore the stock redemption does not result in a constructive distribution to B. Also assume that the special rule of paragraph (c)(2) of this section does not apply. Accordingly, under paragraphs (a)(1) and (b)(1) of this section, the tax consequences of the redemption shall be determined in accordance with its form as a redemption of A's shares by Corporation X. See section 302.

Example 4. Assume the same facts as *Example 3*, except that the divorce instrument provides as follows: "A and B agree the redemption shall be treated, for federal income tax purposes, as resulting in a constructive distribution to B." The divorce instrument further provides that it "supersedes any other instrument or agreement concerning the purchase, sale, redemption, or other disposition of the stock that is the subject of the redemption." By virtue of the special rule of paragraph (c)(2) of this section, the redemption is treated as resulting in a constructive distribution to B for purposes of paragraph (a)(2) of this section. Accordingly, under paragraphs (a)(2) and (b)(2) of this

section, A shall be treated as transferring A's stock of Corporation X to B in a transfer to which section 1041 applies (assuming the requirements of section 1041 are otherwise satisfied), B shall be treated as transferring the Corporation X stock B is deemed to have received from A to Corporation X in exchange for a note in an exchange to which section 1041 does not apply and sections 302(d) and 301 apply, and B shall be treated as transferring the note to A in a transfer to which section 1041 applies.

(e) *Effective date.* Except as otherwise provided in this paragraph, this section is applicable to redemptions of stock on or after January 13, 2003, except for redemptions of stock that are pursuant to instruments in effect before January 13, 2003. For redemptions of stock before January 13, 2003, and redemptions of stock that are pursuant to instruments in effect before January 13, 2003, see §1.1041-1T(c), A-9. However, these regulations will be applicable to redemptions described in the preceding sentence of this paragraph (e) if the spouses or former spouses execute a written agreement on or after August 3, 2001, that satisfies the requirements of one of the special rules in paragraph (c) of this section with respect to such redemption. A divorce or separation instrument or valid written agreement executed on or after August 3, 2001, and before May 13, 2003, that meets the requirements of the special rule in Regulations Project REG-107151-00 published in 2001-2 C.B. 370 (see §601.601(d)(2) of this chapter) will be treated as also meeting the requirements of the special rule in paragraph (c)(2) of this section.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

* * * * *

1.1041-2 1545-1751

* * * * *

David A. Mader,
*Assistant Deputy Commissioner of
Internal Revenue.*

Approved December 30, 2002.

Pamela F. Olson,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 10,
2003, 8:45 a.m., and published in the issue of the Federal Reg-
ister for January 13, 2003, 68 F.R. 1534)

Section 6103.—Confiden- tiality and Disclosure of Returns and Return Information

26 CFR 301.6103(p)(2)(B)–1: *Disclosure of returns
and return information by other agencies.*

T.D. 9036

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 301 and 602

Disclosure of Returns and Return Information by Other Agencies

AGENCY: Internal Revenue Service (IRS),
Treasury.

ACTION: Final regulations.

SUMMARY: This document contains a final regulation relating to the disclosure of returns and return information by federal, state, and local agencies other than the IRS. The final regulation permits the IRS to authorize agencies with access to returns and return information under section 6103 of the Internal Revenue Code (Code) to redisclose returns and return information, with the approval of the Commissioner of Internal Revenue (Commissioner), to any authorized recipient set forth in section 6103, subject to the same conditions and restric-

tions, and for the same purposes, as if the recipient had received the information from the IRS directly.

DATES: This regulation is effective January 21, 2003.

**FOR FURTHER INFORMATION CON-
TACT:** Julie C. Schwartz, 202-622-4570
(not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 4507(d)) under control number 1545-1757. The collection of information in this regulation is in §301.6103(p)(2)(B)–1. This information is required for the Commissioner to authorize the disclosure of returns and return information from agencies with access to returns and return information under section 6103 to other authorized recipients of returns and return information in accordance with section 6103.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The estimated annual burden per respondent varies from one half-hour to two hours, depending on individual circumstances, with an estimated average of one hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long

as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR parts 301 and 602. On December 13, 2001, a notice of proposed rulemaking (REG-105344-01, 2002-2 I.R.B. 302 [66 FR 64386]) was published in the **Federal Register**. No comments were received from the public in response to the notice of proposed rulemaking. No public hearing was requested or held. The proposed regulations are adopted by this Treasury decision.

Explanation of Provisions

The final regulation expands the number of agencies that may redisclose returns and return information if authorized by the Commissioner to any federal, state, or local agency that receives such information under section 6103. Similarly, it expands the universe of authorized recipients of returns and return information pursuant to this redisclosure authority to any recipient authorized to receive returns and return information in accordance with section 6103. All redisclosures by agencies pursuant to this regulation will be made subject to the same conditions, restrictions, safeguards, recordkeeping requirements, and civil and criminal penalties that would apply if the disclosure were made by the IRS. Federal, state and local agencies making disclosures of return information under the final regulation will continue to provide to the IRS certain information regarding disclosures made pursuant to this authority, in order for the IRS to fulfill its reporting requirements under section 6103(p).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment

is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this final rule will not have a significant economic impact on a substantial number of small entities. The disclosure authorized by the rule is voluntary on the part of small governmental jurisdictions and, as discussed earlier in this preamble, the burden associated with requesting authorization from the Commissioner to disclose returns and return information, and to maintain the necessary records concerning the disclosure of return information, is minimal. Accordingly, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel of the Small Business Administration for comment on their impact on small businesses.

Drafting Information

The principal author of these regulations is Julie C. Schwartz, Office of the Associate Chief Counsel (Procedure and Administration), Disclosure and Privacy Law Division.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 301 and 602 are amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 ***

Section 301.6103(p)(2)(B)–1 also issued under 26 U.S.C. 6103(p)(2);***

Par. 2. Section 301.6103(p)(2)(B)–1 is added to read as follows:

§301.6103(p)(2)(B)–1 Disclosure of Returns and Return Information by Other Agencies.

(a) *General rule.* Subject to the requirements of paragraphs (b), (c), and (d) of this section, returns or return information that have been obtained by a federal, state, or local agency, or its agents or contractors, in accordance with section 6103 (the first recipient) may be disclosed by the first recipient to another recipient authorized to receive such returns or return information under section 6103 (the second recipient).

(b) *Approval by Commissioner.* A disclosure described in paragraph (a) of this section may be made if the Commissioner of Internal Revenue (the Commissioner) determines, after receiving a written request under this section, that such returns or return information are more readily available from the first recipient than from the Internal Revenue Service (IRS). The disclosure authorization by the Commissioner shall be directed to the head of the first recipient and may contain such conditions or restrictions as the Commissioner may prescribe. The disclosure authorization may be revoked by the Commissioner at any time.

(c) *Requirements and restrictions.* The second recipient may receive only returns or return information as authorized by the provision of section 6103 applicable to such second recipient. Any returns or return information disclosed may be used by the second recipient only for a purpose authorized by and subject to any conditions imposed by section 6103 and the regulations thereunder, including, if applicable, safeguards imposed by section 6103(p)(4).

(d) *Records and reports of disclosure.* The first recipient shall maintain to the sat-

isfaction of the IRS a permanent system of standardized records regarding such disclosure authorization described in paragraph (a) of this section and any disclosure of returns and return information made pursuant to such authorization, and shall provide such information as prescribed by the Commissioner in order to enable the IRS to comply with its obligations under section 6103(p)(3) to keep accountings for disclosures and to make annual reports of disclosures to the Joint Committee on Taxation. The information required for reports to the Joint Committee on Taxation must be provided within 30 days after the close of each calendar year. The requirements of this paragraph do not apply to the disclosure of returns and return information as provided by paragraph (a) of this section which, had such disclosures been made directly by the IRS, would not have been subject to the recordkeeping requirements imposed by section 6103(p)(3)(A).

(e) *Effective date.* This section is applicable on January 21, 2003.

§301.6103(p)(2)(B)–1T [Removed]

Par. 3. Section 301.6103(p)(2)(B)–1T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Paragraph 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805 ***

Paragraph 5. In §602.101, paragraph (b) is amended by removing the entry “301.6103(p)(2)(B)–1T” from the table and adding the entry “301.6103(p)(2)(B)–1” in numerical order to read as follows:

§602.101 OMB Control numbers.

(b)***

CFR part or section where identified and described

Current OMB control No.

301.6103(p)(2)(B)–11545–1757

David A. Mader,
*Assistant Deputy Commissioner of
Internal Revenue.*

Approved December 20, 2002.

Pamela F. Olson,
*Assistant Secretary of
the Treasury (Tax Policy).*

(Filed by the Office of the Federal Register on January 17, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 21, 2003, 68 F.R. 2695)

26 CFR 301.6103(j)(1)–1: Disclosures of return information reflected on returns to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

T.D. 9037

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

Disclosure of Return Information to the Bureau of the Census

AGENCY: Internal Revenue Service (IRS),
Treasury.

ACTION: Final regulations and removal of
temporary regulations.

SUMMARY: This document contains regulations relating to the list of items of tax information disclosed to the Bureau of the Census. These regulations reflect an agreement between the IRS and the Bureau of the Census as to items of tax information needed to more effectively meet the Bureau of the Census' program objectives as authorized under chapter 5 of title 13, United States Code (U.S.C.), including the Longitudinal Employer-Household Dynamics (LEHD) project and the Survey of Income and Program Participation (SIPP) project.

DATES: *Effective Date:* These regulations are effective January 21, 2003.

FOR FURTHER INFORMATION CONTACT: Christine Irwin, (202) 622–4570 (not a toll-free number).

Background

This document contains amendments to 26 CFR part 301 under section 6103(j) of the Internal Revenue Code (Code). On February 13, 2001, the **Federal Register** published temporary regulations (T.D. 8943, 2001–15 I.R.B. 1054 [66 FR 9957]) regarding tax information disclosed to the Bureau of the Census for use in the LEHD and SIPP projects, and a notice of proposed rulemaking (REG–121109–00, 2001–15 I.R.B. 1064 [66 FR 9991]) cross-referencing the temporary regulations. A correction to the notice of proposed rulemaking by cross-reference to the temporary regulations was published on March 23, 2001 (66 FR 16161). Three comments on these temporary regulations were received and considered, but no public hearing was requested or held. After consideration of the comments, the Treasury decision adopts the regulations as proposed with certain changes and removes the corresponding temporary regulations.

The changes include corrections to punctuation and clarification of certain terms used in the regulations, *e.g.*, references to Form SS–4 as a “form” as opposed to a tax “return.” Additional changes include adopting the generic term “location code” to refer to locations of IRS offices from which tax information is retrieved. Changes also include using the terms “area/district office” and “campus/service” center as examples of location codes. The tax information disclosed to the Bureau of the Census is retrieved from older files, as well as current files. The older information is retrieved from files which contain the terms “district offices” and “service centers” as the location codes, while the more recent information is retrieved from files that use the terms “area offices” and “campuses” (in addition to other location codes). Although the terms “district offices” and “service centers” are no longer used by the IRS, having been replaced by the terms “area offices” and “campuses” respectively, as a result of the IRS reorganization mandated by section 1001 of the IRS Restructuring and Reform Act of 1998, the regulations' reference to “location code” will encompass all of these terms to ensure that tax information may be retrieved from both older and more current files.

Also, the final regulations narrow the tax information to be disclosed to the Bureau of the Census under §301.6103(j)(1)–

1(b)(3)(xxviii) pertaining to “Gross Distributions from Form 1099–R.” Although the temporary regulations authorized the disclosure of all gross distributions from Form 1099–R under §301.6103(j)(1)–1T(b)(3)(xxviii), the Bureau of the Census needs only tax information related to distributions from employer-sponsored and individual retirement plans, according to a letter sent to the IRS from the Secretary of Commerce dated October 4, 2002. Therefore, the final regulations authorize the disclosure only of distributions from employer-sponsored and individual retirement plans from the Forms 1099–R under §301.6103(j)(1)–1(b)(3)(xxviii).

The final regulations also clarify the phrase “return information reflected on returns” — language that was incorporated into §301.6103(j)(1)–1 when the regulations were first promulgated in 1980 (see T.D. 7724, 1980–2 C.B. 360 [45 FR 65561]). The phrase “return information reflected on returns” is used in the regulations to describe the type of return information that may be disclosed to agencies under sections 6103(j)(1)(A) and (B) of the Code. (The phrase “return information reflected on returns” encompasses the phrases used in the statute under section 6103(j)(1)(A) and (B) of the Code that refer to “return information reflected thereon” and “return information reflected on returns of corporations.”) The legislative history of section 6103(j)(1)(A) of the Code, authorizing the disclosure of “returns” and “return information reflected thereon” to officers and employees of the Bureau of the Census, does not specifically define the phrase “return information reflected thereon.” Nor does the legislative history of section 6103(j)(1)(B) of the Code, authorizing the disclosure of “return information reflected on returns of corporations” to officers and employees of the Bureau of Economic Analysis, define the phrase “return information reflected on returns of corporations.” These final regulations clarify the concept of “return information reflected on returns.” Although the legislative history does not explicitly define the concept of “return information reflected on returns,” it does use the term “information from tax returns” and expresses Congress' intent that only “limited information” for statistical purposes should be provided to the Bureau of the Census and the Bureau of Economic Analysis. The legisla-

tive history does describe the type of information that the IRS provided to agencies when section 6103(j)(1) and (2) of the Code was enacted in the Tax Reform Act of 1976. This information included IRS transcript cards that summarized information from 500 to 1,000 returns of the largest corporations, taxpayer names, addresses, employer identification numbers, gross receipts, accounting periods, industry codes, and sample codes. (See Staff of Joint Committee on Internal Revenue Taxation, 94th Cong., 2d Sess., Tax Revision Issues — 1976 (H.R. 10612), No. 6: Administrative Matters, at 40–41 (Comm. Print, April 14, 1976) (Joint Committee Report)). According to the legislative history, the “sample code” provided the “sampling process used by the IRS with respect to its Statistics of Income (not with respect to audit, etc.)” See Joint Committee Report at 41. These sample codes were not information submitted by taxpayers on tax returns filed with the IRS. Rather, these codes were information generated by the IRS in conjunction with returns and disclosed by the IRS to at least one agency for statistical purposes. Therefore, when Congress enacted section 6103(j)(1)(A) and (B) of the Code in 1976, adopting the language “return information reflected thereon” and “such return information reflected on returns of corporations” to describe the type of information that could be disclosed to agencies for statistical purposes, the information described includes not only information on returns, but also information derived from the processing of such returns, and/or information related to the establishment and maintenance of taxpayer information in IRS data bases, such as sample codes. Therefore, these final regulations clarify the phrase “return information reflected on returns” by stating that it includes, but is not limited to, information on returns, information derived from processing such returns, and information derived from the Social Security Administration (SSA) and other sources for the purposes of establishing and maintaining taxpayer information relating to returns. This includes information derived from returns and Forms SS–4, “*Application for Employer Identification Number*,” monthly corrections of, and additions to, taxpayer information contained in IRS and SSA databases (e.g., taxpayer address and name changes) that are ob-

tained from SSA and other sources, and computer codes compiled by the IRS and the SSA derived from returns and/or tax forms and integrated within taxpayer data bases.

Further, these final regulations clarify a restriction that was imposed by the temporary regulations with respect to the disclosure of tax information to the Bureau of the Census. Specifically, the explanation of provisions section to the temporary regulations stated that information will be furnished under the temporary regulations only for the purposes of conducting the LEHD project and/or SIPP/SSA project as specified in the request letters and with the understanding that the information will be used strictly in accordance with the provisions of the Code pertaining to confidentiality (see 66 FR 9958 under “Explanation of Provisions” of the preamble). These tax disclosure restrictions to the LEHD and SIPP projects were included during the inception of an agreement entered into between the IRS and the Bureau of the Census that provides detailed criteria for the review and approval by the IRS of Census Bureau projects that use federal tax information. This inter-agency agreement between the IRS and the Bureau of the Census dated September 15, 2000, is entitled “Criteria for the Review and Approval of Census Projects that Use Federal Tax Information” (inter-agency agreement) and provides detailed procedures for implementing the requirements set forth in §301.6103(j)(1)–1(d) of the regulations. According to §301.6103(j)(1)–1(d) of the regulations and the inter-agency agreement, the IRS must approve the proposed uses for tax information disclosed on a project-by-project basis. The implementation of this inter-agency agreement has strengthened the IRS’ review process for approving proposed uses for tax information disclosed to the Bureau of the Census. It has also improved the ability of the IRS and the Bureau of the Census to ensure that appropriate procedures, especially relating to safeguards and approved usage documentation, are employed for access to, and use of, federal tax information.

Although the explanation of provisions section to the temporary regulations stated that the additional tax information authorized for disclosure under the temporary regulations under §301.6103(j)(1)–1T(b)(2),

(3), and (5) would be disclosed only for purposes of conducting the LEHD and/or SIPP projects, the actual language of the temporary regulations under §301.6103(j)(1)–1T(b)(2), (3), and (5) did not contain such a limitation. Rather, the temporary regulations adopted the same language describing the authorized use of the tax information by the Bureau of the Census that appeared in §301.6103(j)(1)–1(b)(2), (3), and (5) of the previous regulations (prior to the implementation of the temporary regulations). This language authorizes a broader use of the disclosed tax information by the Bureau of the Census for demographic and economic statistics programs, censuses, and surveys authorized by chapter 5 of title 13, U.S.C. These final regulations do not change this language pertaining to the authorized uses of the tax information by the Bureau of the Census in §301.6103(j)(1)–1(b)(2), (3), and (5). Accordingly, these final regulations permit the disclosure of tax information to the Bureau of the Census, not only for the LEHD and SIPP projects, but also to the extent necessary in conducting and preparing demographic and economic statistics programs, censuses, and surveys, as authorized by chapter 5 of title 13, U.S.C., and as approved for these purposes by the IRS according to procedures reflected in the September 15, 2000, inter-agency agreement described above and §301.6103(j)(1)–1(d) of the regulations.

Summary of Comments

With respect to the three comments received in response to the temporary regulations, two strongly supported, and one objected to, the additional disclosure of tax information to the Bureau of the Census. Specifically, two of the comments supported the additions to the list of items of tax information disclosed to the Bureau of the Census for use in the SIPP project. One comment stated that these additional disclosures to the Census Bureau will make it possible to provide an accurate measure of prospective pension benefits that is critically important in providing estimates of the future economic well-being of an increasingly large segment of the population and will provide legislators, policy analysts, and researchers with a much more

useful measure of the net government transfers to different households than that provided by the current SIPP. These additional disclosures will also provide a crucial source of information for assessing potential reforms of the Social Security System, according to the comment.

The third comment expressed opposition to the compiling of data by the Bureau of Census beyond that necessary to determine population distribution for the purpose of legislative redistricting. This objection does not recognize that the Bureau of the Census is authorized under chapter 5 of title 13, U.S.C., to conduct various demographic, economic, and agricultural statistics programs and censuses and related program evaluation that includes the LEHD and SIPP projects. Therefore, the comment was not adopted.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rule-making preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Christine Irwin, Office of the Associate Chief Counsel, Procedure & Administration (Disclosure & Privacy Law Division).

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by removing the en-

try for “Section 301.6103(j)(1)–IT” and continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 301.6103(j)(1)–1 is revised to read as follows:

§301.6103(j)(1)–1 Disclosures of return information reflected on returns to officers and employees of the Department of Commerce for certain statistical purposes and related activities.

(a) *General rule.* Pursuant to the provisions of section 6103(j)(1) of the Internal Revenue Code and subject to the requirements of paragraph (d) of this section, officers or employees of the Internal Revenue Service will disclose return information (as defined by section 6103(b)(2) but not including return information described in section 6103(o)(2)) reflected on returns to officers and employees of the Department of Commerce to the extent, and for such purposes as may be, provided by paragraphs (b) and (c) of this section. Further, in the case of any disclosure of return information reflected on returns so provided by paragraphs (b) and (c) of this section, the tax period or accounting period to which such information relates will also be disclosed. “Return information reflected on returns” includes, but is not limited to, information on returns, information derived from processing such returns, and information derived from the Social Security Administration and other sources for the purposes of establishing and maintaining taxpayer information relating to returns.

(b) *Disclosure of return information reflected on returns to officers and employees of the Bureau of the Census.*

(1) Officers or employees of the Internal Revenue Service will disclose the following return information reflected on returns of individual taxpayers to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of title 13, United States Code, intercensal estimates of population and income for all geographic areas included in the population estimates program and demographic statistics programs, censuses, and related program evaluation:

(i) Taxpayer identity information (as defined in section 6103(b)(6) of the Internal Revenue Code), validity code with respect to the taxpayer identifying number (as de-

scribed in section 6109), and taxpayer identity information of spouse and dependents, if reported.

(ii) Location codes (including area/district office and campus/service center codes).

(iii) Marital status.

(iv) Number and classification of reported exemptions.

(v) Wage and salary income.

(vi) Dividend income.

(vii) Interest income.

(viii) Gross rent and royalty income.

(ix) Total of—

(A) Wages, salaries, tips, etc.;

(B) Interest income;

(C) Dividend income;

(D) Alimony received;

(E) Business income;

(F) Pensions and annuities;

(G) Income from rents, royalties, partnerships, estates, trusts, etc.;

(H) Farm income;

(I) Unemployment compensation; and

(J) Total Social Security benefits.

(x) Adjusted gross income.

(xi) Type of tax return filed.

(xii) Entity code.

(xiii) Code indicators for Form 1040, Form 1040 (Schedules A, C, D, E, F, and SE), and Form 8814.

(xiv) Posting cycle date relative to filing.

(xv) Social Security benefits.

(2) Officers or employees of the Internal Revenue Service will disclose to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting, as authorized by chapter 5 of title 13, United States Code, demographic, economic, and agricultural statistics programs and censuses and related program evaluation—

(i) From the business master files of the Internal Revenue Service—the taxpayer name directory and entity records consisting of taxpayer identity information (as defined in section 6103(b)(6)) with respect to taxpayers engaged in a trade or business, the principal industrial activity code, the filing requirement code, the employment code, the physical location, the location codes (including area/district office and campus/service center codes), and monthly corrections of, and additions to, such entity records;

(ii) From Form SS-4—all information reflected on such form;

(iii) From an employment tax return—

(A) Taxpayer identifying number (as described in section 6109) of the employer;
(B) Total compensation reported;
(C) Master file tax account code (MFT);
(D) Taxable period covered by such return;

(E) Employer code;

(F) Document locator number;

(G) Record code;

(H) Total number of individuals employed in the taxable period covered by the return;

(I) Total taxable wages paid for purposes of chapter 21; and

(J) Total taxable tip income reported for purposes of chapter 21;

(iv) From Form 1040 (Schedule SE)—

(A) Taxpayer identifying number of self-employed individual;

(B) Business activities subject to the tax imposed by chapter 21;

(C) Net earnings from farming;

(D) Net earnings from nonfarming activities;

(E) Total net earnings from self-employment; and

(F) Taxable self-employment income for purposes of chapter 2;

(v) Total Social Security taxable earnings; and

(vi) Quarters of Social Security coverage.

(3) Officers or employees of the Internal Revenue Service will disclose the following business related return information reflected on returns of taxpayers to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of title 13, United States Code, demographic and economic statistics programs, censuses, and surveys. (The "returns of taxpayers" include, but are not limited to: Form 941; Form 990 series; Form 1040 series and Schedules C and SE; Form 1065 and all attending schedules and Form 8825; Form 1120 series and all attending schedules and Form 8825; Form 851; Form 1096; and other business returns, schedules and forms that the Internal Revenue Service may issue.):

(i) Taxpayer identity information (as defined in section 6103(b)(6)) including parent corporation, shareholder, partner, and employer identity information.

(ii) Gross income, profits, or receipts.

(iii) Returns and allowances.

(iv) Cost of labor, salaries, and wages.

(v) Total expenses or deductions.

(vi) Total assets.

(vii) Beginning- and end-of-year inventory.

(viii) Royalty income.

(ix) Interest income, including portfolio interest.

(x) Rental income, including gross rents.

(xi) Tax-exempt interest income.

(xii) Net gain from sales of business property.

(xiii) Other income.

(xiv) Total income.

(xv) Percentage of stock owned by each shareholder.

(xvi) Percentage of capital ownership of each partner.

(xvii) End-of-year code.

(xviii) Months actively operated.

(xix) Principal industrial activity code, including the business description.

(xx) Total number of documents and the total amount reported on the Form 1096 transmitting Forms 1099-MISC.

(xxi) Form 941 indicator and business address on Form 1040 (Schedule C).

(xxii) Consolidated return indicator.

(xxiii) Wages, tips, and other compensation.

(xxiv) Social Security wages.

(xxv) Deferred wages.

(xxvi) Social Security tip income.

(xxvii) Total Social Security taxable earnings.

(xxviii) Gross distributions from employer-sponsored and individual retirement plans from Form 1099-R.

(4) Officers or employees of the Internal Revenue Service will disclose return information reflected on returns of taxpayers contained in the exempt organization master files of the Internal Revenue Service to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by chapter 5 of title 13, United States Code, economic censuses. This return information reflected on returns of taxpayers consists of taxpayer identity information (as defined in section 6103(b)(6)), activity codes, and filing requirement code, and monthly corrections of, and additions to, such information.

(5) Subject to the requirements of paragraph (d) of this section and §301.6103(p)(2)(B)-1, officers or employees of the Social Security Administration to whom the following return information reflected on re-

turns has been disclosed as provided by section 6103(l)(1)(A) or (l)(5) may disclose such information to officers and employees of the Bureau of the Census for necessary purposes described in paragraph (b)(2) or (3) of this section:

(i) From Form SS-4—all information reflected on such form.

(ii) From Form 1040 (Schedule SE)—

(A) Taxpayer identifying number of self-employed individual;

(B) Business activities subject to the tax imposed by chapter 21;

(C) Net earnings from farming;

(D) Net earnings from nonfarming activities;

(E) Total net earnings from self-employment; and

(F) Taxable self-employment income for purposes of chapter 2.

(iii) From Form W-2, and related forms and schedules—

(A) Social Security number;

(B) Employer identification number;

(C) Wages, tips, and other compensation;

(D) Social Security wages; and

(E) Deferred wages.

(iv) Total Social Security taxable earnings.

(v) Quarters of Social Security coverage.

(6)(i) Officers or employees of the Internal Revenue Service will disclose the following return information (but not including return information described in section 6103(o)(2)) reflected on returns of corporations with respect to the tax imposed by chapter 1 to officers and employees of the Bureau of the Census for purposes of, but only to the extent necessary in, developing and preparing, as authorized by law, the Quarterly Financial Report:

(A) From the business master files of the Internal Revenue Service—

(1) Taxpayer identity information (as defined in section 6103(b)(6)), including parent corporation identity information;

(2) Document code;

(3) Location codes (including area/district office and campus/service center codes);

(4) Consolidated return and final return indicators;

(5) Principal industrial activity code;

(6) Partial year indicator;

(7) Annual accounting period;

(8) Gross receipts less returns and allowances; and

(9) Total assets.

(B) From Form SS-4—

(1) Month and year in which such form was executed;

(2) Taxpayer identity information; and

(3) Principal industrial activity, geographic, firm size, and reason for application codes.

(ii) Subject to the requirements of paragraph (d) of this section and §301.6103(p)(2)(B)-1, officers or employees of the Social Security Administration to whom return information reflected on returns of corporations described in paragraph (b)(6)(i)(B) of this section has been disclosed as provided by section 6103(l)(1)(A) or (l)(5) may disclose such information to officers and employees of the Bureau of the Census for a purpose described in this paragraph (b)(6).

(iii) Return information reflected on employment tax returns disclosed pursuant to paragraphs (b)(2)(iii)(A), (B), (D), (I) and (J) of this section may be used by officers and employees of the Bureau of the Census for the purpose described in and subject to the limitations of this paragraph (b)(6).

(c) *Disclosure of return information reflected on returns of corporations to officers and employees of the Bureau of Economic Analysis.* (1) Officers or employees of the Internal Revenue Service will disclose to officers and employees of the Bureau of Economic Analysis for purposes of, but only to the extent necessary in, conducting and preparing, as authorized by law, statistical analyses return information consisting of Statistics of Income transcript-edit sheets containing return information reflected on returns of designated classes or categories of corporations with respect to the tax imposed by chapter 1 of the Internal Revenue Code and microfilmed records of return information reflected on such returns where needed for further use

in connection with such conduct or preparation.

(2) Subject to the requirements of paragraph (d) of this section and §301.6103(p)(2)(B)-1, officers and employees of the Social Security Administration to whom the following return information reflected on returns of designated classes or categories of corporations has been disclosed as provided by section 6103(l)(1)(A) or (l)(5) may disclose such information to officers and employees of the Bureau of Economic Analysis for necessary purposes described in paragraph (c)(1) of this section:

(i) From Form SS-4—Principal industrial activity and geographic codes.

(ii) From an employment tax return—

(A) Total compensation reported; and

(B) Taxable wages paid for purposes of chapter 21 to each employee.

(d) *Procedures and restrictions.* Disclosure of return information reflected on returns by officers or employees of the Internal Revenue Service or the Social Security Administration as provided by paragraphs (b) and (c) of this section will be made only upon written request to the Commissioner of Internal Revenue by the Secretary of Commerce describing—

(1) The particular return information reflected on returns to be disclosed;

(2) The taxable period or date to which such return information reflected on returns relates; and

(3)(i) The particular purpose for which the return information reflected on returns is to be used, and designating by name and title the officers and employees of the Bureau of the Census or the Bureau of Economic Analysis to whom such disclosure is authorized.

(ii) No such officer or employee to whom return information reflected on returns is disclosed pursuant to the provisions of paragraph (b) or (c) of this section shall disclose such information to any per-

son, other than the taxpayer to whom such return information reflected on returns relates or other officers or employees of such bureau whose duties or responsibilities require such disclosure for a purpose described in paragraph (b) or (c) of this section, except in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer. If the Internal Revenue Service determines that the Bureau of the Census or the Bureau of Economic Analysis, or any officer or employee thereof, has failed to, or does not, satisfy the requirements of section 6103(p)(4) of the Internal Revenue Code or regulations or published procedures thereunder (see §601.601(d)(2) of this chapter), the Internal Revenue Service may take such actions as are deemed necessary to ensure that such requirements are or will be satisfied, including suspension of disclosures of return information reflected on returns otherwise authorized by section 6103(j)(1) and paragraph (b) or (c) of this section, until the Internal Revenue Service determines that such requirements have been or will be satisfied.

(e) *Effective date.* This section is applicable to the Bureau of the Census on January 21, 2003.

§301.6103(j)(1)-1T [Removed]

Par. 3. Section 301.6103(j)(1)-1T is removed.

David A. Mader,
*Assistant Deputy Commissioner of
Internal Revenue.*

Approved December 20, 2002.

Pamela F. Olson,
*Assistant Secretary of the
Treasury (Tax Policy).*

(Filed by the Federal Register on January 17, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 21, 2003, 68 F.R. 2691)

Part III. Administrative, Procedural, and Miscellaneous

Proposed Revenue Procedure Regarding Finality of Adoptions

Notice 2003-15

This notice provides a proposed revenue procedure that would establish certain safe harbors for determining the finality of the adoption of a foreign-born child for purposes of the adoption credit and the exclusion for employer-provided assistance for qualified adoption expenses.

The proposed revenue procedure applies to qualified adoption expenses paid or incurred in connection with the adoption of a foreign-born child who has received an “immediate relative” (IR) visa from the Department of State. The Department of State issues an IR visa only to a foreign-born child who enters the United States pursuant to a decree of adoption or guardianship granted by a court or other governmental agency (“competent authority”) with jurisdiction over child welfare matters in a foreign-sending country. Thus, the proposed revenue procedure does not apply to the adoption of a child who is a citizen or resident of the United States at the time the adoption proceedings commence.

The proposed revenue procedure provides that a taxpayer may treat an adoption of a foreign-born child who receives an IR-3 visa as final for federal income tax purposes in the taxable year in which the competent authority enters a decree of adoption. The adoption of a foreign-born child who receives an IR-4 visa and enters the United States under a guardianship or legal custody arrangement may be treated as final for federal income tax purposes in the taxable year in which a court of the home state enters a decree of adoption. A taxpayer who adopts a foreign-born child who receives an IR-2 visa, or who receives an IR-4 visa and enters the United States under a decree of simple adoption, may treat the adoption as final for federal income tax purposes in the taxable year in which a home state court enters a decree of re-adoption or the home state otherwise recognizes the adoption decree of the foreign-sending country.

The Service requests general comments on the proposed revenue procedure. The

Service also requests specific comments on the following matters:

(1) Whether other specified events (such as the date on which a foreign-born child obtains United States citizenship) should be treated as safe harbors, either in addition to or in lieu of events provided in the proposed revenue procedure;

(2) Whether the term “enters a decree of adoption” is sufficiently precise (in light of variations in the laws of foreign countries and of states within the United States, and of the possibility that a decree of adoption might be appealed or otherwise contested) to establish a reliable date for determining the finality of an adoption, and if not, what term is more precise; and

(3) Whether the phrase “the taxable year in which a home state court enters a decree of re-adoption or the home state otherwise recognizes the adoption decree of the foreign-sending country” is sufficiently broad to encompass the manner in which various states acknowledge the existence of a parent-child relationship and, if not, what phrase is more encompassing.

Comments should be submitted by June 2, 2003, either to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:T:CRU (ITA)
Room 5529

or electronically at: *Notice.Comments@irscounsel.treas.gov* (the Service’s comments e-mail address). All comments are available for public inspection and copying.

Although the revenue procedure is in proposed form, the Internal Revenue Service will not challenge the finality of adoptions by taxpayers who apply the proposed revenue procedure in any taxable years for which the period of limitation under § 6511 of the Internal Revenue Code has not expired on February 11, 2003.

Rev. Proc. 2003—

SECTION 1. PURPOSE

This revenue procedure provides certain safe harbors for establishing the finality of the adoption of a foreign-born child for federal income tax purposes.

SECTION 2. BACKGROUND

.01 Section 23 of the Internal Revenue Code allows a credit for qualified adoption expenses paid or incurred by an individual in connection with the adoption of an eligible child. Section 137 allows an exclusion from an employee’s gross income for qualified adoption expenses paid or incurred by the employer under an adoption assistance program. See Notice 97-9, 1997-1 C.B. 365, for general guidance concerning the credit under § 23 and the exclusion under § 137.

.02 Section 23(d)(2) provides that an eligible child includes any individual who has not attained age 18, or who is physically or mentally incapable of caring for himself. However, under § 23(d)(1)(C), no credit or exclusion is allowed for the adoption of a stepchild.

.03 Section 23(a)(2) provides the general rule that, for qualified adoption expenses paid or incurred in a taxable year before the adoption is final, the credit is allowed in the next taxable year after the taxable year in which the qualified adoption expenses are paid or incurred. For qualified adoption expenses paid or incurred during or after the taxable year in which the adoption is final, the credit is allowed in the taxable year in which the qualified adoption expenses are paid or incurred.

.04 Section 23(e) provides, in the case of an adoption of an otherwise eligible child who is not a citizen or resident of the United States at the time the adoption commences (“foreign adoption”), that: (1) the credit is allowed only if the adoption becomes final, and (2) qualified adoption expenses paid or incurred in any taxable year before the taxable year in which the adoption becomes final are treated as paid or incurred in the taxable year in which the adoption becomes final. Similar rules apply for purposes of the exclusion under § 137 for employer-provided adoption assistance.

.05 Therefore, for a foreign adoption, qualified adoption expenses paid or incurred before the taxable year in which the adoption becomes final, or during the taxable year in which the adoption becomes final, are allowed as a credit under § 23 in the taxable year in which the adoption becomes final. Similarly, the exclusion under § 137 for amounts furnished by an emp-

loyer before or during the taxable year in which a foreign adoption becomes final is allowed for the taxable year in which the adoption becomes final.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers who claim the adoption credit or exclusion for qualified adoption expenses related to a foreign-born child. This revenue procedure does not apply to taxpayers who adopt or attempt to adopt an eligible child who is a United States citizen or resident at the time the adoption procedure commences.

SECTION 4. DEFINITIONS

.01 *Foreign-born child.* An individual who is not a citizen or resident of the United States at the time the adoption commences but who is otherwise an eligible child within the meaning of § 23(d)(2).

.02 *Orphan.* A foreign-born child under the age of 16 at the time an immigration petition is filed on the child's behalf who has suffered the death or disappearance of, abandonment or desertion by, or separation or loss from, both parents, or for whom the sole or surviving parent is incapable of providing the proper care and has in writing irrevocably released the foreign-born child for emigration and adoption.

.03 *Foreign-sending country.* The country of citizenship of a foreign-born child, or if the foreign-born child is not permanently residing in the country of citizenship, the country of the child's habitual residence before adoption.

.04 *Competent authority.* A court or governmental agency of the foreign-sending country with jurisdiction and authority to make decisions in matters of child welfare, including adoption (as provided in 8 C.F.R. § 204.3 (2001)).

.05 *Home state.* The state (including the District of Columbia and possessions) in which the adopted child and adoptive parents make their habitual residence in the United States.

.06 *Full and final adoption.* An adoption of an orphan in which the competent

authority of the foreign-sending country enters a decree of adoption establishing a parent-child relationship and both adoptive parents (in adoptions by two parents) or the sole adoptive parent (in adoptions by one parent) see the orphan before or during the adoption proceeding.

.07 *Simple adoption.* An adoption of a foreign-born child in which the competent authority of the foreign-sending country enters a decree of adoption establishing a parent-child relationship under the laws of that foreign-sending country, but in which either (1) one or both of the adoptive parents do not see the foreign-born child before or during the adoption proceeding (in the case of an orphan receiving an IR-4 visa), or (2) the foreign-born child receives an IR-2 visa.

.08 *Re-adoption.* An adoption or other recognition proceeding under home state law occurring subsequent to the entry of a foreign-born child into the United States on an IR-4 or IR-2 visa.

.09 *IR-2 visa.* A visa issued to a foreign-born child adopted while under the age of 16 years who has been in the legal custody of, and has resided with, the adoptive parent or parents for at least 2 years.

.10 *IR-3 visa.* A visa issued to an orphan after a full and final adoption of the orphan has occurred in the foreign-sending country. An IR-3 visa is issued if: (1) the competent authority of the foreign-sending country severs the parental rights of the biological or any previous adoptive parents and establishes a parent-child relationship between the orphan and the adoptive parent or parents, and (2) both adoptive parents (in adoptions by two parents) or the sole adoptive parent (in adoptions by one parent) see the orphan before or during the adoption proceeding.

.11 *IR-4 visa.* An IR-4 visa issued to an orphan if: (1) the competent authority of the foreign-sending country grants legal guardianship or custody either to the prospective adoptive parent or parents or to an individual or agency acting on behalf of the prospective adoptive parent or parents, or (2) a simple adoption occurs in the foreign-sending country.

SECTION 5. APPLICATION

.01 *IR-3 visa.* If a taxpayer adopts an orphan in a full and final adoption and the orphan receives an IR-3 visa, the taxpayer may treat the adoption as final for federal income tax purposes in the taxable year in which the competent authority enters the decree of adoption.

.02 *IR-4 visa.* A taxpayer who adopts an orphan who receives an IR-4 visa and enters the United States under a guardianship or legal custody arrangement may treat the adoption as final for federal income tax purposes in the taxable year in which a home state court enters a decree of adoption. A taxpayer who adopts an orphan who receives an IR-4 visa and enters the United States under a decree of simple adoption may treat the adoption as final for federal income tax purposes in the taxable year in which a home state court enters a decree of re-adoption or the home state otherwise recognizes the adoption decree of the foreign-sending country.

.03 *IR-2 visa.* A taxpayer who adopts a foreign-born child who receives an IR-2 visa may treat the adoption as final for federal income tax purposes in the taxable year in which a home state court enters a decree of re-adoption or the home state otherwise recognizes the adoption decree of the foreign-sending country.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective for expenses paid or incurred after [date of publication of final revenue procedure]. However, the Service will not challenge the finality of adoptions by taxpayers who apply this revenue procedure in any taxable year for which the period of limitation under § 6511 has not expired.

DRAFTING INFORMATION

The principal author of this notice is Marilyn E. Brookens of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Brookens at (202) 622-4920 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations; Notice of Public Hearing; and Withdrawal of Previous Notice of Proposed Rulemaking

Statutory Mergers and Consolidations

REG-126485-01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations; notice of public hearing; and withdrawal of previous notice of proposed rulemaking.

SUMMARY: In T.D. 9038 on page 524 of this issue of the Bulletin, the IRS is issuing temporary regulations relating to transactions involving corporations engaging in statutory mergers and consolidations. The text of those regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations. This document also withdraws the notice of proposed rulemaking published in the **Federal Register** (REG-126485-01, 2001-2 C.B. 555 [66 FR 57400]) on November 15, 2001.

DATES: Written or electronic comments and outlines of topics to be discussed at the public hearing scheduled for May 21, 2003, at 10 a.m. must be received by April 24, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-126485-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG-126485-01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in room 4718 of the Internal Revenue

Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Richard M. Heinecke or Reginald Mombrun at (202) 622-7930; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On November 15, 2001, the IRS and Treasury published in the **Federal Register** at 66 FR 57400 a notice of proposed rulemaking (REG-126485-01) under section 368(a)(1)(A) of the Internal Revenue Code of 1986 (Code). Those proposed regulations are withdrawn.

Temporary regulations on page 524 of this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 368(a)(1)(A). The temporary regulations set forth certain definitions and explanations with respect to certain transactions that qualify as statutory mergers and consolidations. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 21, 2003, beginning at 10 a.m. in room 4718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 24, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Richard M. Heinecke, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Withdrawal of Proposed Amendments

Accordingly, under the authority of 26 U.S.C. 7805, the proposed amendment to 26 CFR part 1 that was published in the **Federal Register** on Thursday, November 15, 2001 (66 FR 57400) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.368–2, paragraph (b)(1) is revised to read as follows:

§1.368–2 Definition of terms.

[The text of proposed §1.368–2 is the same as the text of §1.368–2T published elsewhere in this issue of the **Federal Register**.]

David A. Mader,
*Assistant Deputy Commissioner
of Internal Revenue.*

(Filed by the Office of the Federal Register on January 23, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 24, 2003, 68 F.R. 3477)

Notice of Proposed Rulemaking and Notice of Public Hearing

Noncompensatory Partnership Options

REG–103580–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the tax treatment of noncompensatory options and convertible instruments issued by a partnership. The proposed regulations generally provide that the exercise of a noncompensatory option does not cause the recognition of immediate income or loss by either the issuing partnership or the op-

tion holder. The proposed regulations also modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Additionally, the proposed regulations contain a characterization rule providing that the holder of a noncompensatory option is treated as a partner under certain circumstances. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by April 29, 2003. Requests to speak and outlines of oral comments to be discussed at the public hearing scheduled for May 20, 2003, at 10 a.m. must be received by April 29, 2003.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–103580–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:ITA:RU (REG–103580–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS internet site at www.irs.gov/regs. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Audrey W. Ellis, (202) 622–3060; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In a variety of situations, partnerships issue options or convertible instruments that allow the holder to acquire by purchase or conversion an equity interest in the partnership. On June 5, 2000, Treasury and the IRS issued Notice 2000–29, 2000–1 C.B. 1241, inviting public comment on the federal income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest, and the exchange of a

preferred interest in a partnership for a common interest in that partnership.

In response to Notice 2000–29, Treasury and the IRS received a number of comments. Many commentators requested guidance on the treatment of options and other instruments that are issued by partnerships in connection with the performance of services (compensatory options).

These proposed regulations apply to certain call options, warrants, convertible debt, and convertible preferred equity that are not issued in connection with the performance of services (noncompensatory options). To expedite the issuance of guidance, these regulations do not address compensatory options. Nothing in the proposed regulations should be construed as creating any inference regarding the proper federal income tax treatment of compensatory options. However, Treasury and the IRS are working on future guidance that will address the federal income tax consequences of compensatory options and invite comments. In particular, Treasury and the IRS request comments on the proposed amendment to §1.721–1(b)(1) that was published in the **Federal Register** on June 3, 1971 (36 FR 10787), and, more particularly, on the application of section 83 to the issuance of compensatory options and partnership capital interests in connection with the performance of services. In addition, Treasury and the IRS request comments on how to coordinate the tax treatment of partnership profits interests issued in connection with the performance of services (see Rev. Proc. 93–27, 1993–2 C.B. 343, as clarified in Rev. Proc. 2001–43, 2001–2 C.B. 191) with the tax treatment of options to acquire partnership capital interests issued in connection with the performance of services.

Explanation of Provisions

1. Scope of Proposed Regulations

The proposed regulations describe certain of the income tax consequences of issuing, transferring, and exercising noncompensatory options. These proposed regulations apply only if the call option, warrant, or conversion right entitles the holder to the right to acquire an interest in the issuer (or to cash or property having a value equal to the value of such an interest).

The proposed regulations generally provide that the exercise of a noncompensatory option does not cause recognition of

gain or loss to either the issuing partnership or the option holder. In addition, the proposed regulations modify the regulations under section 704(b) regarding the maintenance of the partners' capital accounts and the determination of the partners' distributive shares of partnership items. Finally, the proposed regulations contain a characterization rule providing that the holder of a call option, warrant, convertible debt, or convertible preferred equity issued by a partnership (or an eligible entity, as defined in §301.7701-3(a), that would become a partnership if the option holder were treated as a partner) is treated as a partner under certain circumstances.

The rule providing for nonrecognition of gain or loss on the exercise of a noncompensatory option does not apply to any call option, warrant, or convertible debt issued by an eligible entity, as defined in §301.7701-3(a), that would become a partnership under §301.7701-3(f)(2) if the option, warrant, or conversion right were exercised. Treasury and the IRS request comments on whether the nonrecognition rule should be extended to such instruments.

2. Issuance, Exercise, and Lapse of Noncompensatory Options

Section 721(a) and §1.721-1 provide that, with certain exceptions, no gain or loss is recognized to a partnership or any of its partners on the contribution of property to a partnership in exchange for an interest in the partnership. However, §1.721-1 does not provide clear guidance as to the tax consequences to the holder of a noncompensatory option and the partnership upon the issuance, lapse, and exercise of a noncompensatory option to acquire a partnership interest. Many taxpayers have requested guidance clarifying the tax consequences of these transactions.

Generally, the proposed regulations do not treat the issuance of a noncompensatory option as a transaction described in section 721. Therefore, the issuance of a noncompensatory option is taxed under general tax principles. Under these principles, the issuance of a noncompensatory call option or warrant (stand-alone option) is generally an open transaction for the issuer. The issuer's income or loss from the noncompensatory stand-alone option does not become fixed and determinable until the lapse, exercise, repurchase, or other termination

of the option. For the holder of the noncompensatory stand-alone option, the purchase of the option is merely an investment in the option — a capital expenditure that is neither taxable to nor deductible by the holder. See Rev. Rul 78-182, 1978-1 C.B. 265. However, if the holder uses appreciated or depreciated property (property with a value greater or less than the holder's basis in the property) to acquire the noncompensatory stand-alone option, then the holder recognizes gain or loss in accordance with the provisions of section 1001, subject to the generally applicable rules governing the allowance of losses, such as section 707(b).

The proposed regulations do not change the rules relating to the issuance of convertible debt or convertible equity. Under general tax principles, the conversion right embedded in convertible debt or convertible equity typically is taken into account for tax purposes as part of the underlying instrument.

The proposed regulations also provide guidance on the tax consequences resulting from the exercise of a noncompensatory option. Section 1.721-1(b) provides that, to the extent that a partner gives up his right to be repaid all or a portion of his capital contribution in favor of another partner "as compensation for services (or in satisfaction of an obligation)," section 721 does not apply. Some commentators have expressed a concern that this regulation could be read to exclude from the application of section 721 a shift in partnership capital from the historic partners to the holder of the noncompensatory option in satisfaction of the partnership's option obligation upon exercise of the option. If this were the case, the partnership could be deemed to have sold a portion of each of its assets to the holder in a taxable exchange. Alternatively, the partnership could be deemed to have sold a partnership interest with a \$0 basis to the option holder in a taxable exchange.

Despite these concerns, most commentators believe that §1.721-1(b)(1) should not cause the issuance of a partnership interest upon exercise of a noncompensatory option to be taxable. They assert that the exercise of such an option should be nontaxable to the holder and the partnership, both under general tax principles applicable to noncompensatory options and un-

der the policy of section 721 to facilitate business combinations through the pooling of capital.

Treasury and the IRS agree that, in general, the issuance of a partnership interest to the holder of a noncompensatory option should not be taxable to the holder or the partnership. Upon exercise, the option holder may be viewed as contributing property in the form of the premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest. Generally, this is a transaction to which section 721 should apply — a transaction through which persons join together in order to conduct a business or make investments. Accordingly, the proposed regulations generally provide that section 721 applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership.

The proposed regulations do not describe the tax consequences (to the partnership or the holder) of a right to convert partnership debt into an interest in the issuing partnership to the extent of any accrued but unpaid interest on the debt (including accrued original issue discount). On the one hand, based on *Carman v. Commissioner*, 189 F.2d 363 (2d Cir. 1951), it might be argued that the interest obligation is inseparable from the debt and that both are property for purposes of section 721. On the other hand, it may be appropriate to require a partnership to recognize gain to the extent of the accrued but unpaid interest, because the issuance of the partnership interest satisfies a deductible (or capital) expense of the partnership. As this issue is closely related to the tax treatment of the exercise of compensatory options, Treasury and the IRS have decided to consider this issue in the course of preparing guidance on compensatory options. Treasury and the IRS request comments on the proper treatment of the exercise of convertible debt to the extent of accrued, but unpaid, interest (including original issue discount) on the debt.

The proposed regulations also clarify that section 721 does not apply to the lapse of a noncompensatory option. If a noncompensatory option lapses, the former option holder does not contribute property to the partnership in exchange for an interest in the partnership. Accordingly, consistent with general tax principles, the lapse

of a noncompensatory option generally results in the recognition of income by the partnership and the recognition of loss by the former option holder.

3. Accounting for Noncompensatory Options

The proposed regulations also contain rules to assist partnerships in properly accounting for any shifts in capital that may result from the exercise of noncompensatory options.

Generally, upon the exercise of a noncompensatory option, the option holder receives a partnership interest with a value that is greater or less than the aggregate value of the premium and exercise price that the option holder contributes to the partnership. In other words, the option privilege represents an asset with built-in gain or loss, *i.e.*, an asset to which section 704(c) would apply. However, because the option privilege terminates upon its contribution to the partnership, the partnership cannot allocate gain or loss from the option privilege to the option holder under section 704(c)(1)(A). To address this problem, the proposed regulations generally allow partnerships to substitute built-in gain or loss in the partnership's assets for the built-in gain or loss in the option.

The proposed regulations achieve this result by providing that a noncompensatory option holder's initial capital account is equal to the consideration paid to the partnership to acquire the noncompensatory option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the noncompensatory option. The proposed regulations then require the partnership to revalue its property immediately following the exercise of the noncompensatory option, when the holder has become a partner. Under the proposed regulations, the partnership must allocate the unrealized income, gain, loss, and deduction from this revaluation, first, to the noncompensatory option holder, to the extent necessary to reflect the holder's right to share in partnership capital under the partnership agreement, and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date. To the extent that un-

realized appreciation or depreciation in the partnership's assets has been allocated to the capital account of the noncompensatory option holder, the holder will, under section 704(c) principles, recognize any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated, or amortized.

In some cases, the built-in gain or loss in the option will exceed the unrealized appreciation or depreciation in the partnership's assets (that has not been reflected in the partners' capital accounts previously). In those cases, even after all of the unrealized appreciation or depreciation in the partnership's assets has been allocated to the option holder, a disparity may remain between the noncompensatory option holder's right to share in partnership capital and the value of money and other property contributed by the partner. Most commentators have recommended and Treasury and the IRS agree that the partnership nevertheless should be allowed to shift capital between the historic partners and the noncompensatory option holder on the exercise of the noncompensatory option.

Some commentators also have suggested that the historic partners and the noncompensatory option holder should be allocated notional tax items over the recovery period for partnership assets similar to the remedial allocations that are permitted, but not required, under the regulations issued under section 704(c)(1)(A). Although the use of section 704(c) notional tax items would ensure that the noncompensatory option holder and the historic partners receive the proper amount of income and loss over time, Treasury and the IRS believe that implementing such a system would be unduly complex where the built-in gain or loss to be allocated to the noncompensatory option holder exceeds the built-in gain or loss in the partnership's assets.

Instead, the proposed regulations require that the partnership make corrective allocations of gross income or loss to the partners in the year in which the option is exercised so as to take into account any shift in the partners' capital accounts that occurs as a result of the exercise of a noncompensatory option. These corrective allocations are allocations of tax items that differ from the partnership's allocations of book items. If there are not sufficient actual partnership items in the year of exercise to conform the partnership's tax

allocations to the capital shift, additional corrective allocations are required in succeeding taxable years until the capital shift has been fully taken into account.

The proposed regulations also provide rules for revaluing the partners' capital accounts while a noncompensatory option is outstanding. Section 1.704-1(b)(2)(iv) contains rules for maintaining a partnership's capital accounts. Section 1.704-1(b)(2)(iv)(f) provides that a partnership may, upon the occurrence of certain events (including the contribution of money to the partnership by a new or existing partner), increase or decrease the partners' capital accounts to reflect a revaluation of partnership property. If one or more options are outstanding when a revaluation occurs, and the revaluation does not account for the value associated with the outstanding options, the partners' capital accounts will not reflect the true economic value of their interests. For example, in partnerships with appreciated property, the historic partners' capital accounts often would overstate the distributions that would be made to the partners if the partnership were liquidated, because a portion of the partnership's assets may ultimately be paid to the option holder. Therefore, the proposed regulations modify §1.704-1(b)(2)(iv)(f) and (h) to provide that any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value, if any, of outstanding options.

4. Characterization Rule

Under section 704(b), a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined under the partnership agreement if the allocation under the agreement has substantial economic effect. If the allocation does not have substantial economic effect, or the partnership agreement does not provide for the allocation, then the allocation must be made in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances). Section 1.704-1(b)(2)(ii)(h) provides in part that, for this purpose, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not

embodied in a document referred to by the partners as the partnership agreement, including puts, options, and buy-sell agreements. Currently, there is some uncertainty about the extent to which these rules require a partnership to take into account a noncompensatory option to acquire an interest in a partnership when making its annual allocations.

Treasury and the IRS believe that it is appropriate to clarify these rules with respect to noncompensatory options addressed in this project. As these proposed regulations are limited to noncompensatory options, nothing in these proposed regulations provides any inference as to the operation of this rule for compensatory options or other types of agreements.

Given the uncertainty of the exercise of most noncompensatory options, Treasury and the IRS believe that noncompensatory options generally should not be treated as entitling the holder to a fixed right to share in partnership income until the option is exercised. However, if a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, then the holder should be treated as a partner and the option should be taken into account in allocating partnership income. At the same time, Treasury and the IRS recognize that treating a noncompensatory option holder as a partner may, in some circumstances, frustrate the intent of the parties without substantially altering their aggregate tax liabilities.

For these reasons, the proposed regulations generally respect noncompensatory options as such and do not characterize them as partnership equity. However, the proposed regulations contain a rule that characterizes the holder of a noncompensatory option as a partner if the option holder's rights are substantially similar to the rights afforded to a partner. This rule applies only if, as of the date that the noncompensatory option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate tax liabilities.

The proposed regulations use a facts and circumstances test to determine whether a noncompensatory option holder's rights are substantially similar to the rights afforded

to a partner, including whether the option is reasonably certain to be exercised and whether the option holder has partner attributes. The proposed regulations list a number of factors that are used to determine whether a noncompensatory option is reasonably certain to be exercised, including the premium paid for the option, the exercise price of the option, the term of the option, the predictability and stability of the value of the underlying partnership interest, and whether the partnership is expected to make distributions during the term of the option. If a noncompensatory option is reasonably certain to be exercised, then the holder of the option ordinarily has rights that are substantially similar to the rights afforded to a partner. Partner attributes include the extent to which the option holder shares in the economic benefit and detriment of partnership income and loss and the extent to which the option holder has the right to participate in the management of the partnership.

If the holder of a noncompensatory option is treated as a partner under the proposed regulations, then the holder's distributive share of the partnership's income, gain, loss, deduction, or credit (or items thereof) generally must be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances) as determined under §1.704-1(b)(3). For this purpose, the partner's interest in the partnership generally must reflect the economic differences between holding an option to acquire a partnership interest and holding the partnership interest itself. For example, unlike a partner, a noncompensatory option holder is not required initially to contribute to the partnership the full amount of the purchase price for the partnership interest. Instead, the noncompensatory option holder generally pays an option premium that is considerably smaller than the purchase price and may wait until the option is about to expire to decide whether to exercise the option and pay the exercise price. The computation of the noncompensatory option holder's share of partnership items should reflect this lesser amount of capital investment to the extent appropriate in a particular case. In addition, a noncompensatory option holder's cumulative distributive share of partnership losses and deductions may be limited under sections 704(b) and (d) to

the amount paid by the holder to the partnership for the option.

5. Original Issue Discount Provisions

The final regulations under the original issue discount (OID) provisions provide special rules for debt instruments convertible into the stock of the issuer. See §§1.1272-1(e), 1.1273-2(j), and 1.1275-4(a)(4). In response to Notice 2000-29, commentators requested that these special rules be extended to apply to debt instruments convertible into partnership interests. Treasury and the IRS agree with the commentators. Treating convertible debt issued by partnerships and corporations differently for purposes of these special rules could create unjustified distinctions between the taxation of instruments that are economically equivalent. Accordingly, the proposed regulations amend the OID provisions to treat partnership interests as stock for purposes of the special rules for convertible debt instruments.

Proposed Effective Date

These regulations are proposed to apply to noncompensatory options that are issued on or after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. Alternatively,

taxpayers may submit comments electronically directly to the IRS Internet site at www.irs.gov/regs. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 20, 2003, beginning at 10 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the FOR FURTHER INFORMATION CONTACT portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and

eight (8) copies) by April 29, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Audrey W. Ellis of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.704–1 is amended as follows:

1. Paragraph (b)(0) is amended by adding entries for 1.704–1(b)(2)(iv)(d)(4), 1.704–1(b)(2)(iv)(h)(I), 1.704–1(b)(2)(iv)(h)(2), 1.704–1(b)(2)(iv)(s), 1.704–1(b)(4)(ix), and 1.704–1(b)(4)(x).

2. Paragraph (b)(1)(ii) is amended by adding a sentence at the end of the paragraph.

3. Paragraph (b)(2)(iv)(d)(4) is added.

4. Paragraph (b)(2)(iv)(f)(I) is revised.

5. Paragraphs (b)(2)(iv)(h)(I) and (2) are redesignated as paragraphs (b)(2)(iv)(h)(I)(i) and (ii), respectively; the text of paragraph (b)(2)(iv)(h) is redesignated as paragraph (b)(2)(iv)(h)(I); a heading is added to new paragraph (b)(2)(iv)(h)(I); and paragraph (b)(2)(iv)(h)(2) is added.

6. Paragraph (b)(2)(iv)(s) is added immediately after the undesignated paragraph that follows paragraph (b)(2)(iv)(r)(2).

7. Paragraphs (b)(4)(ix) and (b)(4)(x) are added.

8. Paragraph (b)(5) is amended by adding *Example 20*, *Example 21*, *Example 22*, *Example 23*, and *Example 24*.

The additions and revisions read as follows:

§1.704–1 Partner’s distributive share.

* * * * *

(b) (0) * * *

Exercise of noncompensatory options 1.704–1(b)(2)(iv)(d)(4)

* * * * *

In general 1.704–1(b)(2)(iv)(h)(I)

* * * * *

Adjustments for noncompensatory options..... 1.704–1(b)(2)(iv)(h)(2)

* * * * *

Adjustments on the exercise of a noncompensatory option 1.704–1(b)(2)(iv)(s)

* * * * *

Allocations with respect to noncompensatory options..... 1.704–1(b)(4)(ix)

Corrective allocations 1.704–1(b)(4)(x)

* * * * *

(1) * * *

(ii) * * * In addition, paragraph (b)(2)(iv)(d)(4), paragraph (b)(2)(iv)(h)(2), paragraph (b)(2)(iv)(s), paragraph (b)(4)(ix), paragraph (b)(4)(x), and *Examples 20* through *24* in paragraph (b)(5) of this section apply to noncompensatory options (as defined in §1.721-2(d)) that are issued on or after the date final regulations are published in the **Federal Register**.

* * * * *

(2) * * *

(iv) * * *

(d) * * *

(4) *Exercise of noncompensatory options.* For purposes of paragraph (b)(2)(iv)(b)(2) of this section, the fair market value of the property contributed on the exercise of a noncompensatory option (as defined in §1.721-2(d)) does not include the fair market value of the option privilege, but does include the consideration paid to the partnership to acquire the option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the option. With respect to convertible equity, the fair market value of the property contributed to the partnership on the exercise of the option includes the converting partner's capital account immediately before the conversion. With respect to convertible debt, the fair market value of the property contributed on the exercise of the option includes the adjusted basis and the accrued but unpaid qualified stated interest on the debt immediately before the conversion. See *Examples 20* through *24* of paragraph (b)(5) of this section.

* * * * *

(f) * * *

(I) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(h) of this section, reduced by the consideration paid to the partnership to acquire any outstanding noncompensatory options (as defined in §1.721-2(d)) that are issued on or after the date final regulations are published in the **Federal Register**. See *Example 22* of paragraph (b)(5) of this section. * * * *

(h) *Determinations of fair market value—(1) In general.* * * *

(2) *Adjustments for noncompensatory options.* The fair market value of partner-

ship property must be adjusted to account for any outstanding noncompensatory options (as defined in §1.721-2(d)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)(f) or (s) of this section. If the fair market value of outstanding noncompensatory options (as defined in §1.721-2(d)) as of the date of the adjustment exceeds the consideration paid by the option holders to acquire the options, then the fair market value of partnership property must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the price paid by the option holders to acquire the outstanding noncompensatory options (as defined in §1.721-2(d)) exceeds the fair market value of such options as of the date of the adjustment, then the value of partnership property must be increased by that excess to the extent of the unrealized deduction or loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation.

* * * * *

(s) *Adjustments on the exercise of a noncompensatory option.* A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in §1.721-2(d)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid by the partner to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(I) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(f) of this section immediately before the exercise of the option, the partnership revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(f)(I) through (4) of this section immediately after the exercise of the option;

(2) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(s)(I) of

this section, the partnership first allocates any unrealized income, gain, loss, or deduction in partnership assets (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income gain, loss, or deduction (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date;

(3) If, after making the allocations described in paragraph (b)(2)(iv)(s)(2) of this section, the exercising partner's capital account still does not reflect that partner's right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account does reflect the exercising partner's right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or reduction in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(s)(3) must be allocated among the existing partners in accordance with the principles of this section; and

(4) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(s)(3) of this section (see paragraph (b)(4)(x) of this section). See *Examples 20* through *24* of paragraph (b)(5) of this section.

* * * * *

(4) * * *

(ix) *Allocations with respect to noncompensatory options.* A partnership agreement may grant to a partner that exercises a noncompensatory option a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid by the partner to acquire and exercise such option. In such a case, allocations of income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding cannot have economic effect, be-

cause, if the noncompensatory option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction. Allocations of partnership income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners' interests in the partnership only if —

(a) The holder of the noncompensatory option is not treated as a partner under §1.761–3;

(b) The partnership agreement requires that, on the exercise of the noncompensatory option, the partnership comply with the rules of paragraph (b)(2)(iv)(s) of this section; and

(c) All material allocations and capital account adjustments under the partnership agreement not pertaining to noncompensatory options are recognized under

section 704(b). See *Examples 20 through 24* of paragraph (b)(5) of this section.

(x) *Corrective allocations.* If partnership capital is reallocated between existing partners and a partner exercising a noncompensatory option under paragraph (b)(2)(iv)(s)(3) of this section (a capital account reallocation), the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the allocations required are fully taken into account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a *pro rata* portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item. See *Example 21* of paragraph (b)(5) of this section.

* * * * *

(5) * * *

Example 20. (i) In Year 1, TM and PK each contribute cash of \$10,000 to LLC, a newly formed limited liability company, classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a nondepreciable property, Property A, for \$20,000. Also in Year 1, at a time when Property A is still valued at \$20,000, LLC issues an option to DH. The option allows DH to buy 100 units in LLC for an exercise price of \$15,000 in Year 2. DH pays \$1,000 to the LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that DH's option is a noncompensatory option under §1.721–2(d), and that DH is not treated as a partner with respect to the option. In Year 2, DH exercises the option, contributing the \$15,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is \$35,000.

Assets			Liabilities and Capital		
	<i>Basis</i>	<i>Value</i>		<i>Basis</i>	<i>Value</i>
Property A	\$20,000	\$35,000	TM	\$10,000	\$17,000
Cash			PK	\$10,000	\$17,000
Premium	\$ 1,000	\$ 1,000	DH	<u>\$16,000</u>	<u>\$17,000</u>
Exercise Price	<u>\$15,000</u>	<u>\$15,000</u>			
Total	\$36,000	\$51,000		\$36,000	\$51,000

(ii) Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, DH's capital account is credited with the amount paid for the option (\$1,000) and the exercise price of the option (\$15,000). Under the LLC agreement, however, DH is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's assets are cash of \$16,000 (\$1,000 premium and \$15,000 exercise price contributed by DH) and Property A, which has a value of \$35,000. Thus, the total value of LLC's assets is \$51,000. DH is entitled to LLC capital equal to 1/3 of this value, or \$17,000. As DH is entitled to \$1,000 more LLC capital than DH's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(iii) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase DH's capital account from \$16,000 to \$17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section and allocating the first \$1,000 of book gain to DH. The net gain in LLC's assets (Property A) is \$15,000 (\$35,000 value less \$20,000 basis). The first \$1,000 of this gain must be allocated to DH, and the remaining \$14,000 of this gain is allocated equally to TM and PK in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases DH's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	TM		PK		DH	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	\$10,000	\$10,000	\$10,000	\$10,000	\$16,000	\$16,000
Revaluation amount	-----	\$ 7,000	-----	\$ 7,000	-----	\$ 1,000
Capital account after revaluation	\$10,000	\$17,000	\$10,000	\$17,000	\$16,000	\$17,000

Example 21. (i) Assume the same facts as in *Example 20*, except that, in Year 1, LLC sells Property A for \$40,000, recognizing gain of \$20,000. LLC does not distribute the sale proceeds to its partners and it has no other earnings in Year 1. With the proceeds (\$40,000), LLC purchases Property B, a nondepreciable property. Also assume that DH exercises the noncompensatory option at the beginning of Year 2 and that, at the time DH exercises the option, the value of Property B is \$41,000. In Year 2, LLC has gross income of \$3,000 and deductions of \$1,500.

Assets			Liabilities and Capital		
	<i>Basis</i>	<i>Value</i>		<i>Basis</i>	<i>Value</i>
Property B	\$40,000	\$41,000	TM	\$20,000	\$19,000
Cash	<u>\$16,000</u>	<u>\$16,000</u>	PK	\$20,000	\$19,000
			DH	<u>\$16,000</u>	<u>\$19,000</u>
Total	\$56,000	\$57,000		\$56,000	\$57,000

(ii) Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, DH's capital account is credited with the amount paid for the option (\$1,000) and the exercise price of the option (\$15,000). Under the LLC agreement, however, DH is entitled to LLC capital corresponding to 100 units of LLC ($\frac{1}{3}$ of LLC's capital). Immediately after the exercise of the option, LLC's assets are \$16,000 cash (\$1,000 option premium and \$15,000 exercise price contributed by DH) and Property B, which has a value of \$41,000. Thus, the total value of LLC's assets is \$57,000. DH is entitled to LLC capital equal to $\frac{1}{3}$ of this amount, or \$19,000. As DH is entitled to \$3,000 more LLC capital than DH's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(iii) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase DH's capital account from \$16,000 to \$19,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the \$1,000 of book gain from the revaluation to DH. This brings DH's capital account to \$17,000. Second, under paragraph (b)(2)(iv)(s)(3) of this section, LLC must reallocate \$2,000 of capital from the existing partners (TM and PK) to DH to bring DH's capital account to \$19,000 (the capital account reallocation). As TM and PK share equally in all items of income, gain, loss, and deduction of LLC, each member's capital account is reduced by $\frac{1}{2}$ of the \$2,000 reduction (\$1,000).

(iv) Under paragraph (b)(2)(iv)(s)(4) of this section, beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the capital account reallocation. In Year 2, LLC has gross income of \$3,000 and deductions of \$1,500. The book gross income of \$3,000 is shared equally by TM, PK, and DH. For tax purposes, however, LLC must allocate all of its gross income (\$3,000) to DH. LLC's deductions (\$1,500) must be allocated equally among TM, PK, and DH. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from Property B must be allocated in accordance with section 704(c) principles.

	TM		PK		DH	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	\$20,000	\$20,000	\$20,000	\$20,000	\$16,000	\$16,000
Revaluation	-----	-----	-----	-----	-----	<u>\$ 1,000</u>
Capital account after revaluation	\$20,000	\$20,000	\$20,000	\$20,000	\$16,000	\$17,000
Capital account reallocation	-----	(\$1,000)	-----	(\$1,000)	-----	<u>\$ 2,000</u>
Capital account after capital account reallocation.....	\$20,000	\$19,000	\$20,000	\$19,000	\$16,000	\$19,000
Income allocation (Yr. 2)	-----	\$ 1,000	-----	\$ 1,000	\$ 3,000	\$ 1,000
Deduction allocation (Yr. 2)	<u>(\$ 500)</u>	<u>(\$ 500)</u>	<u>(\$ 500)</u>	<u>(\$ 500)</u>	<u>(\$ 500)</u>	<u>(\$ 500)</u>
Capital account at end of year 2.....	\$19,500	\$19,500	\$19,500	\$19,500	\$18,500	\$19,500

Example 22. (i) In Year 1, AC and NE each contribute cash of \$10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for \$10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at \$10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of \$15,000 in Year 2. DR pays \$1,000 to LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to non-compensatory options are recognized under section 704(b). Also assume that DR's option is a noncompensatory option under §1.721-2(d), and that DR is not treated as a partner with respect to the option.

(ii) Prior to the exercise of DR's option, ML contributes \$17,000 to LLC for 100 units in LLC. At the time of ML's contribution, Property A has a value of \$30,000 and a basis of \$10,000, Property B has a value of \$5,000 and a basis of \$10,000, and the fair market value of DR's option is \$2,000.

(iii) Upon ML's admission to the partnership, the capital accounts of AC and NE (which were \$10,000 each prior to ML's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward to reflect their shares of the unrealized appreciation in the partnership's assets. Under paragraph (b)(2)(iv)(f)(I) of this section, those adjustments must be based on the fair market value of LLC property (taking section 7701(g) into account) on the date of the adjustment. The fair market value of partnership property (\$36,000) must be reduced by the consideration paid by DR to the partnership to acquire the option (\$1,000) (under paragraph (b)(2)(iv)(f)(I) of this section), and the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by DR to acquire the option (\$1,000) (under paragraph (b)(2)(iv)(h)(2) of this section), but only to the extent of the unrealized appreciation in LLC property (\$15,000). Therefore, the revaluation adjustments must be based on a value of \$34,000. Accordingly, AC and NE's capital accounts must be increased to \$17,000. This \$1,000 reduction is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is \$29,000. The \$19,000 of built-in gain in Property A and the \$5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

Assets				
	<i>Basis</i>	<i>Value</i>	<i>Option Adjustment</i>	<i>704(c) Book</i>
Property A	\$10,000	\$30,000	(\$1,000)	\$29,000
Property B	\$10,000	\$ 5,000	0	\$ 5,000
Cash	<u>\$ 1,000</u>	<u>\$ 1,000</u>	<u>0</u>	<u>\$ 1,000</u>
Subtotal	\$21,000	\$36,000	(\$1,000)	\$35,000
Cash contributed by ML	<u>\$17,000</u>	<u>\$17,000</u>	<u>0</u>	<u>\$17,000</u>
Total	\$38,000	\$53,000	(\$1,000)	\$52,000

Liabilities and Capital		
	<i>Tax</i>	<i>Value</i>
AC	\$10,000	\$17,000
NE	\$10,000	\$17,000
ML	\$17,000	\$17,000
Option	<u>\$ 1,000</u>	<u>\$ 2,000</u>
Total	\$38,000	\$53,000

(iv) After the admission of ML, when Property A still has a value of \$30,000 and a basis of \$10,000 and Property B still has a value of \$5,000 and a basis of \$10,000, DR exercises the option. On the exercise of the option, DR's capital account is credited with the amount paid for the option (\$1,000) and the exercise price of the option (\$15,000). Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC (¼ of LLC's capital). Immediately after the exercise of the option, LLC's assets are worth \$68,000 (\$15,000 contributed by DR, plus the value of LLC assets prior to the exercise of the option, \$53,000). DR is entitled to LLC capital equal to ¼ of this value, or \$17,000. As DR is entitled to \$1,000 more LLC capital than DR's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(v) Under paragraph (b)(2)(iv)(s) of this section, the LLC must increase DR's capital account from \$16,000 to \$17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section and allocating the first \$1,000 of book gain to DR. The net increase in the value of LLC properties since the previous revaluation is \$1,000 (the difference between the actual value of Property A, \$30,000, and the book value of Property A, \$29,000). The entire \$1,000 of book gain is allocated to DR. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases DR's capital account to the amount agreed on by the members, the LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from Properties A and B must be allocated in accordance with section 704(c) principles.

	AC		NE		ML		DR	
	Tax	Book	Tax	Book	Tax	Book	Tax	Book
Capital account after admission of ML....	\$10,000	\$17,000	\$10,000	\$17,000	\$17,000	\$17,000	-----	-----
Capital account after exercise of DH's option	\$10,000	\$17,000	\$10,000	\$17,000	\$17,000	\$17,000	\$16,000	\$16,000
Revaluation	-----	-----	-----	-----	-----	-----	-----	\$ 1,000
Capital account after revaluation	\$10,000	\$17,000	\$10,000	\$17,000	\$17,000	\$17,000	\$16,000	\$17,000

Example 23. (i) On the first day of Year 1, MS, VH, and SR form LLC, a limited liability company classified as a partnership for federal tax purposes. MS and VH each contribute \$10,000 cash to LLC for 100 units of common interest in LLC. SR contributes \$10,000 cash for a convertible preferred interest in LLC. SR's convertible preferred interest entitles SR to receive an annual allocation and distribution of cumulative LLC net profits in an amount equal to 10 percent of SR's unreturned capital. SR's convertible preferred interest also entitles SR to convert, in year 3, SR's preferred interest into 100 units of common interest. If SR converts, SR has the right to the same share of LLC capital as SR would have had if SR had held the 100 units of common interest since the formation of LLC. Under the LLC agreement, each unit of common interest has an equal right to share in any LLC net profits that remains after payment of the preferred return. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that SR's right to convert the preferred interest into a common interest qualifies as a noncompensatory option under §1.721-2(d), and that, prior to the exercise of the conversion right, SR is not treated as a partner with respect to the conversion right.

(ii) LLC uses the \$30,000 to purchase Property Z, a property that is depreciable on a straight-line basis over 15 years. In each of Years 1 and 2, LLC has net income of \$2,500, comprised of \$4,500 of gross receipts and \$2,000 of depreciation. It allocates and distributes \$1,000 of this net income to SR in each year. LLC allocates, but does not distribute, the remaining \$1,500 of net income equally to MS and VH in each year.

	MS		VH		SR	
	Tax	Book	Tax	Book	Tax	Book
Capital account upon formation.....	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000
Allocation of income Years 1 and 2.....	\$ 1,500	\$ 1,500	\$ 1,500	\$ 1,500	\$ 2,000	\$ 2,000
Distributions Years 1 and 2.....	-	-	-	-	(\$2,000)	(\$2,000)
Capital account end of Year 2	\$11,500	\$11,500	\$11,500	\$11,500	\$10,000	\$10,000

(iii) At the beginning of Year 3, when Property Z has a value of \$38,000 and a basis of \$26,000 (\$30,000 original basis less \$4,000 of depreciation) and LLC has accumulated undistributed cash of \$7,000 (\$9,000 gross receipts less \$2,000 distributions), SR converts SR's preferred interest into a common interest. Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, SR's capital account after the conversion equals SR's capital account before the conversion, \$10,000. On the conversion of the preferred interest, however, SR is entitled to LLC capital corresponding to 100 units of common interest in LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC assets is \$45,000. SR is entitled to LLC capital equal to 1/3 of this value, or \$15,000. As SR is entitled to \$5,000 more LLC capital than SR's capital account immediately after the conversion, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

	Assets			Liabilities and Capital	
	Basis	Value		Basis	Value
Property Z	\$26,000	\$38,000	MS	\$11,500	\$15,000
Undistributed			VH	\$11,500	\$15,000
Income	<u>\$ 7,000</u>	<u>\$ 7,000</u>	SR	<u>\$10,000</u>	<u>\$15,000</u>
Total	\$33,000	\$45,000	Total	\$33,000	\$45,000

(iv) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase SR's capital account from \$10,000 to \$15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the first \$5,000 of book gain from that revaluation to SR. The net unrealized gain in LLC's assets (Property Z) is \$12,000 (\$38,000 value less \$26,000 basis). The first \$5,000 of this gain must be allocated to SR. The remaining \$7,000 of that gain must be allocated equally to MS and VH in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases SR's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	MS		VH		SR	
	Tax	Book	Tax	Book	Tax	Book
Capital account prior to conversion.....	\$11,500	\$11,500	\$11,500	\$11,500	\$10,000	\$10,000
Revaluation on conversion.....	-----	\$ 3,500	-----	\$ 3,500	-----	\$ 5,000
Capital account after conversion.....	\$11,500	\$15,000	\$11,500	\$15,000	\$10,000	\$15,000

Example 24. (i) On the first day of Year 1, AK and JP each contribute cash of \$10,000 to LLC, a newly formed limited liability company classified as a partnership for federal tax purposes, in exchange for 100 units in LLC. Immediately after its formation, LLC borrows \$10,000 from JS. Under the terms of the debt instrument, interest of \$1,000 is payable annually and principal is repayable in five years. Throughout the term of the indebtedness, JS has the right to convert the debt instrument into 100 units in LLC. If JS converts, JS has the right to the same share of LLC capital as JS would have had if JS had held 100 units in LLC since the formation of LLC. Under the LLC agreement, each unit participates equally in the profits and losses of LLC and has an equal right to share in LLC capital. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments not pertaining to noncompensatory options are recognized under section 704(b). Also assume that JS's right to convert the debt into an interest in LLC qualifies as a noncompensatory option under §1.721-2(d), and that, prior to the exercise of the conversion right, JS is not treated as a partner with respect to the convertible debt.

(ii) LLC uses the \$30,000 to purchase Property D, property that is depreciable on a straight-line basis over 15 years. In each of Years 1, 2, and 3, LLC has net income of \$2,000, comprised of \$5,000 of gross receipts, \$2,000 of depreciation, and interest expense (representing payments of interest on the loan from JS) of \$1,000. LLC allocates, but does not distribute, this income equally to AK and JP.

	AK		JP		JS	
	Tax	Book	Tax	Book	Tax	Book
Initial capital account	\$10,000	\$10,000	\$10,000	\$10,000	-----	-----
Year 1 net income	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	-----	-----
Year 2 net income	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	-----	-----
Year 3 net income	<u>\$ 1,000</u>	<u>\$ 1,000</u>	<u>\$ 1,000</u>	<u>\$ 1,000</u>	-----	-----
Year 4 initial capital account	\$13,000	\$13,000	\$13,000	\$13,000	0	0

(iii) At the beginning of year 4, at a time when Property D, the LLC's only asset, has a value of \$33,000 and basis of \$24,000 (\$30,000 original basis less \$6,000 depreciation in Years 1 through 3), and LLC has accumulated undistributed cash of \$12,000 (\$15,000 gross receipts less \$3,000 of interest payments) in LLC, JS converts the debt into a 1/3 interest in LLC. Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, JS's capital account after the conversion is the adjusted basis of the debt immediately before JS's conversion of the debt, \$10,000, plus any accrued but unpaid qualified stated interest on the debt, \$0. On the conversion of the debt, however, JS is entitled to receive LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC's assets is \$45,000. JS is entitled to LLC capital equal to 1/3 of this value, or \$15,000. As JS is entitled to \$5,000 more LLC capital than JS's capital contribution to LLC (\$10,000), the provisions of paragraph (b)(2)(iv)(s) of this section apply.

Assets			Liabilities and Capital		
	<i>Basis</i>	<i>Value</i>		<i>Basis</i>	<i>Value</i>
Property D	\$24,000	\$33,000	AK	\$13,000	\$15,000
Cash	<u>\$12,000</u>	<u>\$12,000</u>	JP	\$13,000	\$15,000
			JS	<u>\$10,000</u>	<u>\$15,000</u>
Total	\$36,000	\$45,000		\$36,000	\$45,000

(iv) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase JS's capital account from \$10,000 to \$15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the first \$5,000 of book gain from that revaluation to JS. The net unrealized gain in LLC's assets (Property D) is \$9,000 (\$33,000 value less \$24,000 basis). The first \$5,000 of this gain must be allocated to JS, and the remaining \$4,000 of that gain must be allocated equally to AK and JP in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases JS's capital account to the amount agreed upon by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	AK		JP		JS	
	Tax	Book	Tax	Book	Tax	Book
Year 4 capital account prior to exercise ...	\$13,000	\$13,000	\$13,000	\$13,000	0	0
Capital account after exercise	\$13,000	\$13,000	\$13,000	\$13,000	\$10,000	\$10,000
Revaluation	-----	\$ 2,000	-----	\$ 2,000	-----	\$ 5,000
Capital account after revaluation	\$13,000	\$15,000	\$13,000	\$15,000	\$10,000	\$15,000

Par. 3. Section 1.704-3 is amended by revising the first sentence of paragraph (a)(6)(i) to read as follows:

§1.704-3 Contributed property.

(a) * * *

(6) *Other applications of section 704(c) principles—(i) Revaluations under section 704(b).* The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations). * * *

* * * * *

Par. 4. Section 1.721-2 is added to read as follows:

§1.721-2 Noncompensatory options.

(a) *Exercise of a noncompensatory option.* Notwithstanding §1.721-1(b)(1), sec-

tion 721 applies to the exercise (as defined in paragraph (e)(4) of this section) of a noncompensatory option (as defined in paragraph (d) of this section). However, if the exercise price (as defined in paragraph (e)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the noncompensatory option, the transaction will be given tax effect in accordance with its true nature.

(b) *Transfer of property in exchange for a noncompensatory option.* Section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. For example, if a person purchases a noncompensatory option with appreciated property, the person recognizes income or gain to the extent that the fair market value of the noncompensatory option exceeds the person's basis in the surrendered property.

(c) *Lapse of a noncompensatory option.* Section 721 does not apply to the lapse of a noncompensatory option.

(d) *Scope.* The provisions of this section apply only to noncompensatory options and do not apply to any interest on convertible debt that has been accrued by the partnership (including accrued original issue discount). For purposes of this section, the term noncompensatory option means an option (as defined in paragraph (e)(1) of this section) issued by a partnership (the issuing partnership), other than an option issued in connection with the performance of services.

(e) *Definitions.* The following definitions apply for the purposes of this section.

(1) *Option* means a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt (as defined in paragraph (e)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (e)(3) of this section). A contract that otherwise constitutes an option shall not fail to be treated as such for purposes of this

section merely because it may or must be settled in cash or property other than a partnership interest.

(2) *Convertible debt* is any indebtedness of a partnership that is convertible into an interest in that partnership.

(3) *Convertible equity* is preferred equity in a partnership that is convertible into common equity in that partnership. For this purpose, preferred equity is any interest in the issuing partnership that entitles the partner to a preferential return on capital and common equity is any interest in the issuing partnership that is not preferred equity.

(4) *Exercise* means the exercise of an option or warrant or the conversion of convertible debt or convertible equity.

(5) *Exercise price* means, in the case of a call option or warrant, the exercise price of the call option or warrant; in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion; and, in the case of convertible debt, the adjusted issue price (within the meaning of §1.1275-1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest and by the fair market value of cash or other property contributed to the partnership in connection with the conversion.

(f) *Example.* The following example illustrates the provisions of this section:

Example. In Year 1, L and M form general partnership LM with cash contributions of \$5,000 each, which are used to purchase land, Property D, for \$10,000. In that same year, the partnership issues an option to N to buy a one-third interest in the partnership at any time before the end of Year 3. The exercise price of the option is \$5,000, payable in either cash or property. N transfers Property E with a basis of \$600 and a value of \$1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (d) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with § 1.1001-2, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes \$400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any gain upon receipt of appreciated property in exchange for the option. The partnership has a basis of \$1,000 in Property E. In Year 3, when the partnership property is valued at \$16,000, N exercises the option, contributing Property F with a basis of \$3,000 and a fair market value of \$5,000 to the partnership. Under paragraph

(a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the option. Under section 723, the partnership has a basis of \$3,000 in Property F. See §1.704-1(b)(2)(iv)(d)(4) and (s) for special rules applicable to capital account adjustments on the exercise of a noncompensatory option.

(g) *Effective Date.* This section applies to noncompensatory options that are issued on or after the date final regulations are published in the **Federal Register**.

Par. 5. Section 1.761-3 is added to read as follows.

§1.761-3 Certain option holders treated as partners.

(a) *In general.* A noncompensatory option (as defined in paragraph (b) of this section) is treated as a partnership interest if the option (and any rights associated with it) provides the holder with rights that are substantially similar to the rights afforded to a partner. This paragraph applies only if, as of the date that the noncompensatory option is issued, transferred, or modified, there is a strong likelihood that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities. If the holder of a noncompensatory option is treated as a partner under this section, such partner's distributive share of the partnership's income, gain, loss, deduction or credit (or items thereof) is determined in accordance with that partner's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704-1(b)(3).

(b) *Definitions*—(1) *Noncompensatory option.* For purposes of this section, a noncompensatory option means an option (as defined in paragraph (b)(2) of this section) issued by a partnership, other than an option issued in connection with the performance of services. A noncompensatory option issued by an eligible entity (as defined in §301.7701-3(a)) that would become a partnership under §301.7701-3(f)(2) of this chapter if the option holder were treated as a partner under this section is also a noncompensatory option for purposes of this section. If a noncompensatory option is issued by such an eligible entity, then the eligible entity is treated as a partnership for purposes of applying this section.

(2) *Option.* For purposes of this section, a call option or warrant to acquire an interest in the issuing partnership is an option. In addition, convertible debt (as de-

fined in §1.721-2(e)(2)) and convertible equity (as defined in §1.721-2(e)(3)) are options for purposes of this section. A contract that otherwise constitutes an option shall not fail to be treated as such for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(c) *Rights taken into account.* (1) In determining whether a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, all facts and circumstances are considered, including whether the option is reasonably certain to be exercised (as of the time that the option is issued, transferred or modified) and whether the option holder possesses partner attributes. For purposes of this section, if a noncompensatory option is reasonably certain to be exercised, then the holder of the option ordinarily has rights that are substantially similar to the rights afforded to a partner.

(2) *Reasonable certainty of exercise.* The following factors are relevant in determining whether a noncompensatory option is reasonably certain to be exercised (as of the time that the noncompensatory option is issued, transferred, or modified)—

(i) The fair market value of the partnership interest that is the subject of the option;

(ii) The exercise price of the option;

(iii) The term of the option;

(iv) The volatility, or riskiness, of the partnership interest that is the subject of the option;

(v) The fact that the option premium and, if the option is exercised, the option exercise price, will become assets of the partnership;

(vi) Anticipated distributions by the partnership during the term of the option;

(vii) Any other special option features, such as an exercise price that declines over time or declines contingent on the happening of specific events;

(viii) The existence of related options, including reciprocal options; and

(ix) Any other arrangements (express or implied) affecting the likelihood that the option will be exercised.

(3) *Partner attributes.* Partner attributes include the extent to which the holder of the option will share in the economic benefit of partnership profits (including distributed profits) and in the economic detriment associated with partnership losses.

Partner attributes also include the existence of any arrangement (either within the option agreement or in a related agreement) that, directly or indirectly, allows the holder of a noncompensatory option to control or restrict the activities of the partnership. For this purpose, rights in the partnership possessed by the option holder solely by virtue of owning a partnership interest and not by virtue of holding a noncompensatory option are not taken into account, provided that those rights are no greater than rights granted to other partners owning similar interests in the partnership.

(d) *Examples.* The following examples illustrate the provisions of this section. For the following examples, assume that:

(1) Each option agreement provides that the partnership cannot make distributions to its partners while the option remains outstanding; and

(2) The option holders do not have any significant rights to control or restrict the activities of the partnership (other than restricting distributions and dilutive issuances of partnership equity).

Example 1. Active trade or business. PRS is a partnership engaged in a telecommunications business. In exchange for a premium of \$8x, PRS issues a noncompensatory option to A to acquire a 10 percent interest in PRS for \$17x at any time during a 7-year period commencing on the date on which the option is issued. At the time of the issuance of the option, a 10 percent interest in PRS has a fair market value of \$16x. Due to the riskiness of PRS's business, the value of a 10 percent PRS interest in 7 years is not reasonably predictable as of the time the option is issued. Therefore, it is not reasonably certain that A's option will be exercised. Furthermore, although the option provides A with substantially the same economic benefit of partnership profits as would a direct investment in PRS, A does not share in substantially the same economic detriment of partnership losses as would a partner in PRS. Given these facts, the option to acquire a PRS interest does not provide A with rights that are substantially similar to the rights afforded to a partner. Therefore, A is not treated as a partner under this section.

Example 2. Option issued by partnership with reasonably predictable earnings. PRS owns rental real property. The property is 95 percent rented to corporate tenants with a mid-investment grade bond rating or better and is expected to remain so for the next 20 years. The tenants of the building are responsible for paying all real estate taxes, insurance, and maintenance expenses relating to the property. Occupancy rates in properties of a similar character are high in the geographic area in which the property is located, and it is reasonably predictable that properties in that area will retain their value during the next 10 years. In exchange for a premium of \$6.5x, PRS issues a noncompensatory option to B to acquire a 10 percent interest in PRS for \$17x at the end of a 7-year period commencing on the date of the issuance of the

option. At the time the option is issued, a 10 percent interest in PRS has a fair market value of \$16.5x. Given the stability of PRS's rental property, PRS can reasonably predict that its net cash flow for each of the 7 years during which the option is outstanding will be \$10x (\$70x over the 7 years), and that there will be no decline in the value of the property during that time. In light of the reasonably predictable earnings of PRS and the fact that PRS will make no distributions to its partners during the 7 years that the option is outstanding, it is reasonably certain that the value of a 10 percent interest in PRS at the end of the option's 7-year term will significantly exceed the exercise price of the option. Therefore, the option is reasonably certain to be exercised. Because the option is reasonably certain to be exercised, under these facts, B has rights that are substantially similar to the rights afforded to a partner. Therefore, if there is a strong likelihood that failure to treat B as a partner would result in a substantial reduction in the partners' and B's aggregate tax liabilities, B will be treated as a partner. In such a case, B's distributive share of PRS's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with B's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704-1(b)(3).

Example 3. Deep in the money options. (i) LP is a limited partnership engaged in an internet start-up venture. In exchange for a premium of \$14x, LP issues a noncompensatory option to C to acquire a 5 percent interest in LP for \$6x at any time during a 10-year period commencing on the date on which the option is issued. At the time of the issuance of the option, a 5 percent interest in LP has a fair market value of \$15x. Because of the riskiness of LP's business, the option is not reasonably certain to be exercised. Nevertheless, because C has paid a \$14x premium for a partnership interest that has a fair market value of \$15x, C has substantially the same economic benefits and detriments as a result of purchasing the option as C would have had if C had purchased a partnership interest. Therefore, the option provides C with rights that are substantially similar to the rights afforded to a partner (partner attributes). See paragraph (c)(3) of this section. If there is a strong likelihood that failure to treat C as a partner would result in a substantial reduction in the partners' and C's aggregate tax liabilities, C will be treated as a partner. In such a case, C's distributive share of LP's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with C's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704-1(b)(3).

(ii) The facts are the same as in paragraph (i) of this Example 3, except that C transfers \$150x to LP in exchange for a note from LP that matures 10 years from the date of issuance and a warrant to acquire a 5 percent interest in LP for an exercise price of \$6x. The warrant issued with the debt is exercisable at any time during the 10-year term of the debt. The debt instrument and the warrant comprise an investment unit with the meaning of section 1273(c)(2). Under §1.1273-2(h), the issue price of the investment unit, \$150x, is allocated \$136x to the debt instrument and \$14x to the warrant. As in paragraph (i), C has substantially the same economic benefits and detriments as a result of purchasing the warrant as C would have had if C had purchased a partnership interest. Therefore, the warrant provides C with rights that are substantially similar to the rights afforded to a partner. If there

is a strong likelihood that failure to treat C as a partner would result in a substantial reduction in the partners' and C's aggregate tax liabilities, then C will be treated as a partner. In such a case, C's distributive share of LP's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with C's interest in the partnership (taking into account all facts and circumstances) in accordance with §1.704-1(b)(3).

(e) *Effective Date.* This section applies to noncompensatory options that are issued on or after the date final regulations are published in the **Federal Register**.

Par. 6. Section 1.1272-1 is amended by adding a sentence at the end of paragraph (e) to read as follows:

§1.1272-1 Current inclusion of OID in income.

* * * * *

(e) * * * For debt instruments issued on or after the date final regulations are published in the **Federal Register**, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for federal tax purposes, as either a partnership or a corporation.

* * * * *

Par. 7. Section 1.1273-2 is amended by adding a sentence at the end of paragraph (j) to read as follows:

§1.1273-2 Determination of issue price and issue date.

* * * * *

(j) * * * For debt instruments issued on or after the date final regulations are published in the **federal Register**, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for federal tax purposes, as either a partnership or a corporation.

* * * * *

Par. 8. Section 1.1275-4 is amended by adding a sentence at the end of paragraph (a)(4) to read as follows:

§1.1275-4 Contingent payment debt instruments.

(a) * * *

(4) * * * For debt instruments issued on or after the date final regulations are published in the **Federal Register**, the term *stock* in the preceding sentence means an equity interest in any entity that is classified, for federal tax purposes, as either a partnership or a corporation.

* * * * *

David A. Mader,
*Assistant Deputy Commissioner of
Internal Revenue.*

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Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it

applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Cl.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.

PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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